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**COMMODITY FUTURES TRADING COMMISSION**

**17 CFR Parts 23 and 190**

**RIN 3038-AD28**

**Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy**

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Final rule.

**SUMMARY:** The Commodity Futures Trading Commission (the “Commission”) is issuing final rules implementing new statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Specifically, the final rule contained herein imposes requirements on swap dealers (“SDs”) and major swap participants (“MSPs”) with respect to the treatment of collateral posted by their counterparties to margin, guarantee, or secure uncleared swaps.

Additionally, the final rule includes revisions to ensure that, for purposes of subchapter IV of chapter 7 of the Bankruptcy Code, securities held in a portfolio margining account that is a futures account or a Cleared Swaps Customer Account constitute “customer property”; and owners of such account constitute “customers.”

**DATES:** Effective date: This rule is effective [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

Compliance dates: For uncleared swap transactions that are entered into with “new counterparties,”<sup>1</sup> all persons shall be in compliance with the requirements set forth

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<sup>1</sup> A “new counterparty” is a counterparty with whom, at the time of the effective date of this final rule, no agreement exists between the SD or MSP and that counterparty concerning uncleared swaps.

in Subpart L of Part 23 not later than **[INSERT DATE 180 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. For uncleared swap transactions that are entered into with “existing counterparties,”<sup>2</sup> all persons shall be in compliance with the requirements set forth in Subpart L of Part 23 not later than **[INSERT DATE 360 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. All parties must comply with the Part 190 rules by **[INSERT DATE THAT IS 60 DAYS AFTER PUBLICATION OF THESE RULES IN THE FEDERAL REGISTER]**.

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<sup>2</sup> An “existing counterparty” is a counterparty with whom, at the time of the effective date of this final rule, an agreement exists between the SD or MSP and that counterparty concerning uncleared swaps.

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#### **I. Background**

##### **A. Statutory Background**

On July 21, 2010, President Obama signed the Dodd-Frank Act.<sup>3</sup> Title VII of the Dodd-Frank Act<sup>4</sup> amended the Commodity Exchange Act (“CEA”)<sup>5</sup> to establish a comprehensive new regulatory framework for swaps and certain security-based swaps. The legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (i) providing for the registration and comprehensive regulation of SDs and MSPs; (ii) imposing mandatory clearing and trade execution requirements on clearable swap contracts; (iii) creating recordkeeping and real-time reporting regimes; and (iv) enhancing the rulemaking and enforcement authorities of the Commission with respect to, among others, all registered entities and intermediaries subject to the oversight of the Commission.

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<sup>3</sup> Pub. L. 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at [http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173\\_enrolledbill.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf).

<sup>4</sup> Pursuant to section 701 of the Dodd-Frank Act, Title VII may be cited as the “Wall Street Transparency and Accountability Act of 2010”.

<sup>5</sup> 7 U.S.C. 1 et seq.

Section 724(c) of the Dodd-Frank Act amended the CEA to add section 4s(l), which includes provisions concerning the rights of counterparties to SDs and MSPs with respect to the treatment of such counterparty's margin for uncleared swaps. As discussed further in Part II of this preamble, these changes are implemented in new Subpart L to Part 23 of Title 17, §§23.700 through 23.704.<sup>6</sup>

Section 713(c) of the Dodd-Frank Act amends the CEA to add, as section 20(c) thereof, a provision that requires the Commission to exercise its authority to clarify the legal status, in the event of a commodity broker bankruptcy, of (i) securities in a portfolio margining account held as a futures account, and (ii) an owner of such account.

B. Section 4s(l) of the CEA

Section 4s(l) of the CEA sets forth certain requirements concerning the rights of counterparties of SDs and MSPs with respect to the segregation of money, securities, or other property used to margin, guarantee, or otherwise secure uncleared swaps. These requirements apply only to initial margin. Section 4s(l) requires that:

- an SD or MSP notify each counterparty at the beginning of a swap transaction that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee, or secure the counterparty's obligations;<sup>7</sup> and

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<sup>6</sup> The Commission notes that these rules were proposed as §§23.600 through 23.604. Because other rulemakings use these sections, this final rulemaking will use and reference §§23.700 through 23.704 throughout, notwithstanding the numbering in the proposal.

<sup>7</sup> In a separate rulemaking, the Commission proposed "minimum initial and variation margin requirements" for each SD or MSP for which there is no prudential regulator as a way to "help ensure the safety and soundness of the [SD or MSP]." See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011). Among other things, the Commission proposed to require SDs and MSPs to segregate margin for uncleared swaps that such SD or MSP receives from other SDs and MSPs (hereinafter known as the "SD/MSP Specific Segregation Requirements"). See id. at 23748. Thus, under that proposal, even if an SD or MSP did not exercise its right to require segregation of the funds or other property that it supplies to margin, guarantee, or secure its obligation, such funds or other property would nonetheless be segregated.

- at the request of the counterparty, the SD or MSP shall segregate such funds or other property with an independent third party custodian. The funds or other property of the counterparty must be kept in a segregated account with an independent third party, designated for and on behalf of that counterparty, separate from the assets and other interests of the SD or MSP.

C. Section 20(c) of the CEA

Section 713(c) of the Dodd-Frank Act, codified as section 20(c) of the CEA, directs the Commission to exercise its authority to ensure that securities held in a portfolio margining account carried as a futures account are customer property and the owners of those accounts are customers for the purposes of subchapter IV of chapter 7 of title 11.

## **II. Margin Segregation for SD or MSP Counterparties With Respect to Uncleared Swaps**

The Commission sought public comment on customer collateral protection with respect to money, securities, or other property used to margin, guarantee, or otherwise secure uncleared swaps. First, on October 22, 2010, the Commission, through its staff, held a roundtable to discuss individual customer collateral protection with respect to cleared and uncleared swaps.<sup>8</sup> Following consideration of the comments made during the

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The U.S. banking regulators have proposed similar segregation requirements for those SDs and MSPs that are prudentially regulated and that will be subject to their margin rules. See Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564 (May 11, 2011). The Commission is continuing to consider this proposal in light of this related work by U.S. banking regulators and related efforts by regulators in other countries. The Commission is aware of the importance of developing consistent SD/MSP Specific Segregation Requirements where possible in order to address systemic risk issues and to avoid regulatory arbitrage concerns. See also section 752 of the Dodd-Frank Act.

<sup>8</sup> The transcript from the roundtable is available at: [http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission6\\_102210-transcrip.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission6_102210-transcrip.pdf).

roundtable, on December 3, 2010, the Commission issued a Notice of Proposed Rulemaking (“NPRM”),<sup>9</sup> and sought comment on all aspects of the NPRM, including the definition of initial margin, counterparty notification, the nature of the custodian, and the investment of segregated collateral.<sup>10</sup> The Commission received comments from twenty-two different commenters regarding the proposed regulations in the NPRM.<sup>11</sup> The Commission, through its staff, also met extensively with market participants both prior to and following issuance of the NPRM.

#### A. Regulation 23.700: Definitions

##### 1. “Segregate”

In the NPRM, the Commission proposed to define “segregate” according to its commonly-understood meaning: to keep two or more items in separate accounts, and to avoid combining them in the same transfer between two accounts.

One commenter agreed with the Commission’s proposed definition of “segregate.”<sup>12</sup> Another commenter requested clarification regarding the definition of the

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<sup>9</sup> See Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 FR 75432 (Dec. 3, 2010).

<sup>10</sup> The comment period closed on February 1, 2011, and was reopened for 30 days on May 4, 2011. See Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 25274 (May 4, 2011).

<sup>11</sup> Letters were received from Alternative Investment Management Association Limited (AIMA), American Gas Association (AGA), the Asset Management Group (AMG) of Securities Industry and Financial Markets Association (SIFMA), Edison Electric Institute (EEI), Federal Home Loan Banks (FHLB), Federated Investors, Inc. (Federated), Fidelity Investments (Fidelity), Intercontinental Exchange, Inc. (ICE), International Swaps and Derivatives Association (ISDA), Investment Company Institute (ICI), Managed Funds Association (MFA), MetLife Inc. (MetLife), National Rural Electric Cooperative Association (NRECA), New York City Bar Association (NYCBA), Norges Bank Investment Management (Norges), State Street Corporation (State Street), SIFMA, SIFMA and ISDA (SIFMA/ISDA), and the Working Group of Commercial Energy Firms (Working Group). NYCBA’s letter was a pre-NRPM letter dated November 29, 2010. SIFMA’s letter was a pre-NPRM letter dated October 27, 2010. Federated submitted two letters, both of which focused on the investment of segregated funds. The Commission also received letters from the following individuals: Chris Barnard, Leigh McKeirnan, and Bill Granberry.

<sup>12</sup> See AIMA letter at 2.

term segregate and whether it requires that collateral be held in an individual customer account or whether such term permits an SD or MSP to hold segregated customer collateral in an omnibus customer account.<sup>13</sup> The Commission notes that section 4s(1)(3)(B) requires that a segregated account be “designated as a segregated account for and on behalf of the counterparty.”<sup>14</sup> Moreover, regulation 23.702(b) of the final rules requires initial margin that is segregated pursuant to a counterparty’s election to be held in an account for and on behalf of the counterparty.<sup>15</sup> Thus, regulation 23.702(b) requires initial margin to be held in an individual customer account. As such, the Commission is adopting the definition of “segregate” as proposed.

## 2. “Variation Margin”

The Commission proposed to define “variation margin” (for which a counterparty does not have the right to segregation as section 4s(1)(2)(B)(i) prescribes) as an amount calculated to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market.

Six commenters discussed the “variation margin” definition.<sup>16</sup> SIFMA/ISDA wrote that the concept of variation margin is different in the over-the-counter swaps market than it is in the futures market.<sup>17</sup> In particular, SIFMA/ISDA noted that parties to swaps do not “pay” margin to each other based on mark-to-market prices; rather they post and grant a security interest in collateral based on estimated payment amounts derived

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<sup>13</sup> Working Group letter at 3.

<sup>14</sup> 7 U.S.C. 6s(1)(3)(B).

<sup>15</sup> See discussion in section C.1 infra.

<sup>16</sup> SIFMA/ISDA, ISDA, FHLB, NRECA, AIMA, AMG.

<sup>17</sup> SIFMA/ISDA letter at 2. See also ISDA letter at 2.

from current market conditions.<sup>18</sup> SIFMA/ISDA recommended replacing the term “variation margin” with the term “exposure collateral,” and defining “exposure collateral” to mean “money, securities or property posted by a party to secure its obligations pursuant to the terms of a swap agreement, the amount of which is based on an estimate of the net mark-to-market exposure of all transactions under the master swap agreement.”<sup>19</sup> AIMA wrote that the proposed definition of “variation margin” was appropriate.<sup>20</sup>

The fact that the statute refers to “variation margin” indicates that Congress was contemplating the use of the term “variation margin” as opposed to “exposure collateral.” For the sake of consistency with other regulations, the Commission is amending the definition of “variation margin” to add the phrase “or collateral posted by” after the phrase “a payment made by”. However, the Commission agrees with SIFMA/ISDA’s comments regarding the fact that in the uncleared OTC derivatives markets, parties do not necessarily “pay” variation margin to each other, and instead post collateral.<sup>21</sup> The Commission therefore notes that although the definition of variation margin will include payments, where a payment is made, there would not be any collateral to be segregated. The definition is otherwise being adopted as proposed.

### 3. “Initial Margin”

The Commission proposed to define “initial margin” (for which a counterparty has the right to segregation pursuant to CEA section 4s(1)) as an amount calculated based

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<sup>18</sup> SIFMA/ISDA letter at 2. See also ISDA letter at 2.

<sup>19</sup> SIFMA/ISDA letter at 3. See also ISDA letter at 3.

<sup>20</sup> AIMA letter at 1.

<sup>21</sup> SIFMA/ISDA letter at 2. See also ISDA letter at 2.

on anticipated exposure to future changes in the value of a swap.

Ten commenters addressed the definition of “initial margin.”<sup>22</sup> ICI wrote that the proposed definition of initial margin was too broad, and might be interpreted to also include variation margin.<sup>23</sup> By contrast, Fidelity suggested that “the proposed definition of ‘initial margin’ may be too narrow and could exclude ‘upfront’ deliveries of collateral that should properly be treated as initial margin.”<sup>24</sup> FHLB recommended that the term “independent amount” be used instead of “initial margin.”<sup>25</sup> However, if the Commission elects to use the term “initial margin,” FHLB argued that the definition of “initial margin” should, at the very least, track and reference “independent amount” as it appears in the ISDA documentation.<sup>26</sup> SIFMA/ISDA also recommended that the term “independent amount” be used in the place of “initial margin,” and suggested that “independent amount” be defined to mean “money, securities or property posted by a party to secure its obligations pursuant to the terms of a swap agreement and that is either (i) specified as an [‘independent amount’] in the relevant agreement of the parties or (ii) calculated based upon terms agreed between the parties (in either case, in addition to and separately from any [exposure collateral] requirement).”<sup>27</sup> Chris Barnard suggested that the Commission clarify that initial margin is posted at the commencement or outset of a

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<sup>22</sup> ICI, Fidelity, FHLB, AMG, ISDA, Chris Barnard, AIMA, NRECA, MetLife, SIFMA/ISDA.

<sup>23</sup> ICI letter at 2.

<sup>24</sup> Fidelity letter at 2.

<sup>25</sup> FHLB letter at 6.

<sup>26</sup> FHLB letter at 6. See also AMG letter at 5.

<sup>27</sup> SIFMA/ISDA letter at 2-3. See also ISDA letter at 2-3.

swap transaction as a way to distinguish initial margin from variation margin.<sup>28</sup> AIMA and MetLife wrote that the proposed definition of initial margin was appropriate.<sup>29</sup>

The Commission has considered the comments and understands that some commenters prefer the traditional practice of using the term “independent amount.” However, the statute uses the term “variation margin” and the obvious complimentary term to “variation margin” would be “initial margin.” Moreover, a reference to “independent amount,” by itself, would not be effective, since the definition of “independent amount” in the ISDA “Credit Support Annex” directs the reader to a form.<sup>30</sup> A reference to a form would not be desirable as a definition both because it is ambiguous and because the substance of the form is subject to change. Therefore, the Commission is adopting the definition of initial margin as proposed.

## B. Regulation 23.701: Notification of Right to Segregation

### 1. Required Notification

Proposed regulation 23.601(a)<sup>31</sup> implemented the statutory requirement set forth in section 4s(l)(1)(A) of the CEA. Specifically, with respect to an uncleared swap, proposed regulation 23.601(a) would have required an SD or MSP to notify each of its counterparties that a counterparty has the right to require any initial margin posted by it to be segregated in accordance with Commission regulations.<sup>32</sup> The Commission also

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<sup>28</sup> Chris Barnard letter at 1.

<sup>29</sup> AIMA letter at 1. See also MetLife letter at 3, stating that for purposes of the proposed rule, the definition of initial margin was sufficient, although noting it would request more specific guidance for calculating initial margin in the event of “future use or expanded definition.”

<sup>30</sup> See Paragraph 13 of the ISDA Credit Support Annex. See also definition of “Independent Amount” in the ISDA Credit Support Annex.

<sup>31</sup> As discussed above, section numbers in the NPRM are slightly different from those in this final rulemaking. See supra n. 6. Proposed regulation 23.601(a) is being finalized herein as regulation 23.701(a).

<sup>32</sup> 75 FR at 75433 (Dec. 3, 2010).

stated that it interpreted the language of CEA section 4s(l)(1)(A) as a segregation right that can be elected or renounced by the SD's or MSP's counterparty in its discretion.<sup>33</sup> As stated in the NPRM, Congress's description as a "right" of what would otherwise be a simple matter for commercial negotiation suggests that this decision is an important one, with a certain degree of favor given to an affirmative election.<sup>34</sup> As such, in implementing section 4s(l)(1)(A) the Commission is requiring SDs and MSPs to offer their counterparties segregation that meets the minimum standards set forth in these rules. However, SDs, MSPs and counterparties may negotiate alternative arrangements for the handling of collateral if all parties agree.

In the NPRM, the Commission did not propose specific disclosure requirements with respect to this notification. Instead, the Commission requested comment as to whether the SD or MSP should be required to disclose the price of segregation, the price of fees to be paid to the custodian (if the SD or MSP is aware of the amount of such fees), or differences in the terms of the swap that the SD or MSP is willing to offer to the counterparty (e.g., differences in the fixed interest rate for an interest rate swap) if the counterparty elects or renounces the right to segregation.<sup>35</sup>

Thirteen commenters discussed the costs associated with segregation,<sup>36</sup> with most expressing concern about proper price disclosures by the SDs and MSPs. Two commenters indicated that price disclosure was not particularly important.

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<sup>33</sup> See also CEA section 4s(l)(4) (referring to cases where the counterparty "does not choose to require segregation" of margin). 7 U.S.C. 6s(l)(4).

<sup>34</sup> 75 FR at 75433 (Dec. 3, 2010).

<sup>35</sup> Id.

<sup>36</sup> AMG, MFA, State Street, AGA, Fidelity, ICI, SIFMA/ISDA, ISDA, FHLB, Chris Barnard, AIMA, MetLife, EEI.

Several commenters expressed concern that an SD or MSP would not make counterparties aware of the price associated with segregation and might impose higher prices or offer less attractive terms to counterparties electing segregation.<sup>37</sup> MFA recommended “that the Commission require SDs and MSPs to provide counterparties with robust disclosure of all costs that the SD or MSP will charge to the counterparty if the counterparty elects to segregate its initial margin.”<sup>38</sup> State Street suggested that “the Commission should...provide that, although the pricing of the same transaction with and without a segregated account may differ, the pricing difference should be reflective of actual out-of-pocket costs expected to be incurred by the [SD/MSP] as a result of use of the segregated account, and that the nature and amounts of those costs should be fully disclosed.”<sup>39</sup> AGA argued that, without proper disclosure, counterparties will be forced “to exercise in a vacuum their right to seek segregation of initial margin for an uncleared swap” and suggested that each SD or MSP be required to notify each counterparty as to the price of having a third party hold collateral.<sup>40</sup>

ICI sought to distinguish between fees charged by the custodian – which ICI does not believe need be disclosed by the SD or MSP – and fees embedded in the SD’s swaps pricing for not having access to the customer’s collateral.<sup>41</sup> SIFMA/ISDA do not believe that mandating disclosure is necessary or desirable because “a counterparty can always, in accordance with current market practice, request the disclosures it considers necessary

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<sup>37</sup> AMG letter at 8.

<sup>38</sup> MFA letter at 4.

<sup>39</sup> State Street letter at 3.

<sup>40</sup> AGA letter at 4. See also Fidelity letter at 3.

<sup>41</sup> ICI letter at 3.

from its SD/MSP ... [and] mandatory disclosure by the SD/MSP is impractical because much of the material costs are within the control of a third party: the custodian.”<sup>42</sup>

Finally the FHLB wrote that “it is very important for SDs/MSPs to respond to requests for information regarding the additional costs that may be imposed on end-user counterparties that elect to have initial margin segregated with an independent custodian.”<sup>43</sup>

In light of the concerns expressed by commenters, the Commission has determined that a limited set of disclosures should be required. First, the SD or MSP must inform the counterparty of the price associated with segregation, including custodial fees, to the extent the SD or MSP has such information. It is the Commission’s view that the price of segregation is a material term in any segregation package offered by the SD or MSP. Further, where the custodian is an affiliate of, or a regular custodian for, the SD or MSP, the SD or MSP may be better positioned to know the amount of any such custody costs.<sup>44</sup> In addition, in order for counterparties to make an informed decision as to whether to exercise the right of segregation, the identity of an acceptable custodian(s) is a material aspect of the notification so that counterparties may make informed decisions as to the degree of independence of such custodian(s).<sup>45</sup> As described in more detail in section C.1, below, this notification must include at least one credit-worthy non-

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<sup>42</sup> SIFMA/ISDA letter at 3, ISDA letter at 3-4.

<sup>43</sup> FHLB letter at 7.

<sup>44</sup> However, if the counterparty selects to use an independent custodian (e.g., a non-affiliate of the SD or MSP or a custodian with which the SD or MSP does not have a pre-existing relationship), the SD or MSP may not be required to inform the counterparty of the price of custodianship because the SD or MSP may not have that information.

<sup>45</sup> Several commenters highlighted the importance of have the choice of at least one custodian who is not affiliated with the SD or MSP. See generally EEI letter at 2, AIMA at 2, MFA letter at 4, and Fidelity letter at 5.

affiliate as an option for custodian of segregated initial margin. The Commission has amended regulation 23.701 accordingly.

The Commission notes that certain entities have developed or are in the process of developing electronic platforms through which counterparties could access account information regarding the status of their collateral. The Commission may consider, in a future rulemaking, whether the notification required pursuant to regulation 23.701 should include information from the SD or MSP regarding such platforms.

## 2. Limitation of Right – Variation Margin

Proposed regulation 23.601(b)<sup>46</sup> incorporated the limitation in section 4s(l)(2)(B)(i) of the CEA that the right to segregation does not apply to variation margin. Fidelity recommended that the final rule require that SDs and MSPs “segregate variation margin posted by a counterparty at the counterparty’s request.”<sup>47</sup> Fidelity requested that, at a minimum, the rule clarify that “no change will be necessary to collateral agreements [not in conflict with the rule] ... that involve segregation of all margin, initial and variation....”<sup>48</sup>

The statute clearly excludes variation margin from the 4s(l) segregation requirements.<sup>49</sup> Thus, the request for such a requirement is not supported by the statute. However, the Commission confirms that this rule governs collateral arrangements for swaps entered into on and subsequent to the compliance date and does not affect collateral arrangements agreed to for swaps that are entered into prior to the compliance

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<sup>46</sup> Proposed regulation 23.601(b) is being finalized herein as regulation 23.701(b).

<sup>47</sup> Fidelity letter at 4. See also AMG letter at 6.

<sup>48</sup> Fidelity letter at 3-4.

<sup>49</sup> See section 4s(l)(2)(B)(i) of the CEA.

date. In addition, the Commission notes that this rulemaking does not restrict parties from negotiating segregation arrangements for variation margin.

### 3. Counterparty Notification

The Commission regards the inclusion of the term “right to require segregation” in section 4s(l) of the CEA as requiring that the segregation decision is made by appropriate decision-makers within the counterparty organization. Proposed regulation 23.601(c)<sup>50</sup> would require that the “right to require segregation” notification be made to certain senior decision-makers, in descending order of preference. Notification would be made to the Chief Risk Officer, or the Chief Executive Officer, or to the highest level decision-maker for the SD’s or MSP’s counterparty. The Commission sought comment as to whether this list of decision-makers would be appropriate.

Eleven commenters opposed the requirement that the Chief Risk Officer receive the segregation notification.<sup>51</sup> EEI wrote that this requirement “fails to take into account existing governance and compliance structures and processes developed and implemented by entities for the express purpose of meeting compliance and risk management objectives.”<sup>52</sup> ICI suggested that notices go to “an authorized person to avoid the disruption that would be associated with a [Chief Risk Officer] or other ‘high-level decision-maker’ making an election to each SD or MSP before a trade can settle.”<sup>53</sup> AGA recommended that the notification “be made to the officer in the counterparty responsible for the management of collateral.”<sup>54</sup> ISDA suggested that the counterparty

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<sup>50</sup> Proposed regulation 23.601(c) is being finalized herein as 23.701(c).

<sup>51</sup> SIFMA/ISDA, NRECA, EEI, ICI, AGA, ISDA, AMG, Fidelity, Working Group, AIMA, FHLB.

<sup>52</sup> EEI letter at 3.

<sup>53</sup> ICI letter at 3.

<sup>54</sup> AGA letter at 5.

should identify the proper party to receive notice from the SD or MSP.<sup>55</sup> Similarly, Fidelity wrote that the “final rule should allow the counterparty to select the notice recipient.”<sup>56</sup>

A counterparty’s decision to elect its segregation right is a financial decision that is heavily dependent on such counterparty’s risk assessments. It would seem appropriate, therefore, for a counterparty employee who is involved in the assessment of risk and/or collateral management to receive this notification. However, after consideration of the comments, it is clear that such person does not necessarily need to be the Chief Risk Officer. The Commission agrees with AGA’s comment that a notification should be sent to the “officer in the counterparty responsible for the management of collateral.”<sup>57</sup> If such a person is not identified by the counterparty to the SD or MSP, then the notification should be sent to the Chief Risk Officer and so on, as described in the proposed rule. Regulation 23.701(c) has been amended accordingly.

#### 4. Required Confirmation

Before the terms of an uncleared swap are confirmed, proposed regulation 23.601(d)<sup>58</sup> would require that the SD or MSP obtain from the counterparty (1) confirmation of receipt of the segregation notification by a specified decision-maker, and (2) whether the counterparty has elected to exercise its section 4s(1) segregation rights.

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<sup>55</sup> ISDA letter at 5 and SIFMA/ISDA letter at 4. See also AMG letter at 7, suggesting that notice be made to any party authorized by the counterparty.

<sup>56</sup> Fidelity letter at 3. See also Working Group letter at 5.

<sup>57</sup> AGA letter at 5.

<sup>58</sup> Proposed regulation 23.601(d) is being finalized herein as regulation 23.701(d).

The SD or MSP must maintain records of such confirmation and election as business records in accordance with regulation 1.31.<sup>59</sup>

ICI's comment letter alone addressed this point.<sup>60</sup> ICI agreed with the proposal that "confirmation of receipt of the notification and election to require segregation or not should occur prior to confirming the terms of the uncleared swap."<sup>61</sup> The Commission believes that requiring the SD or MSP to obtain confirmation of receipt of the segregation notification and the counterparty's decision whether to elect segregation prior to confirming the terms of the swaps will provide greater certainty for both parties regarding the counterparty's segregation election. The Commission also agrees that such confirmation should be obtained prior to confirming the terms of the uncleared swap. Therefore, the Commission is adopting paragraph (d) as proposed.

#### 5. Limitation of Responsibility to Notify

Section 4s(l)(1)(A) of the CEA states that an SD or MSP must notify its counterparty of the right to require segregation of funds or other property supplied to margin, guarantee or secure the obligations of the counterparty "at the beginning of a swap transaction." While this language could be read to require transaction-by-transaction notification, where the parties have a preexisting or on-going relationship, such repetitive notification could be redundant, costly and needlessly burdensome. On the other hand, the importance of the segregation decision, as discussed above, suggests that some periodic reconsideration might be appropriate. Proposed regulation 23.601(e)<sup>62</sup>

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<sup>59</sup> 17 CFR 1.31.

<sup>60</sup> ICI letter at 3.

<sup>61</sup> ICI letter at 3. See also discussion in section C.1 infra.

<sup>62</sup> Proposed regulation 23.601(e) is being finalized herein as regulation 23.701(e).

sought to balance these considerations by providing that notification to a particular counterparty by a particular SD or MSP need only be made once in any calendar year.

Twelve commenters discussed issues surrounding the substance and timing of segregation notification,<sup>63</sup> with the primary concern being whether the notification of the right to segregation had to be done on a transaction-by-transaction basis or merely once per year.

The Working Group requested that the rule require notification on segregation no more often than once a year, rather than a transaction-by-transaction notification.<sup>64</sup> Fidelity supported the proposal that notification be required at least annually, stating that this could “prompt a counterparty to reconsider its elections in light of [changes that could occur during the life of a swap transaction].”<sup>65</sup> FHLB and MetLife characterized transaction-by-transaction notification as repetitive and redundant.<sup>66</sup> AGA believes that once a year is an appropriate notification frequency, unless the price of segregation has changed in which case another notice should be delivered.<sup>67</sup>

Several commenters requested that the Commission loosen the once-per-year notification in the Commission’s proposed rule. NRECA, SIFMA/ISDA, AIMA and AMG each wrote that an initial notification is all that should be required – a counterparty’s initial choice should be deemed to apply to all future swaps unless the

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<sup>63</sup> NRECA, Working Group, FHLB, MetLife, EEI, AGA, SIFMA/ISDA, ISDA, AIMA, AMG, Fidelity, ICI.

<sup>64</sup> Working Group letter at 4.

<sup>65</sup> Fidelity letter at 3. See also ICI letter at 3.

<sup>66</sup> FHLB letter at 6, MetLife letter at 2. See also EEI letter at 3.

<sup>67</sup> AGA letter at 5-6.

counterparty seeks to change its election.<sup>68</sup> SIFMA/ISDA proposed “that an [SD or MSP] should only be required to deliver a single notification of the right to segregate, and the counterparty should be deemed to have elected not to require segregation of its [independent amount] until such time as the counterparty duly notifies the [SD or MSP] of its election to require segregation.”<sup>69</sup>

After careful consideration of the comments, the Commission agrees that requiring notification on a transaction-by-transaction basis may be overly costly and burdensome. In addition, the Commission notes the difficulty associated with identifying material changes in the cost of segregation and the burden that would be created should the Commission require that additional notices be delivered upon such event. However, the Commission notes that Congress emphasized the importance of the ability of a counterparty to elect to have its collateral segregated, describing segregation as a “right.” Moreover, the statute does not merely grant counterparties the legal right to segregation; it specifically requires that the existence of this right be communicated to them. The Commission therefore believes that this notification requirement is met when an SD or MSP provides notification to a counterparty, at least once, in each calendar year. Where an SD or MSP does not enter into any swap with the counterparty during a calendar year, the notification requirement would not apply. The Commission believes that such notification requirement would not be overly burdensome, particularly when one considers the importance of the counterparty’s decision to require segregation. Thus, the Commission has decided to adopt the final rule language as proposed.

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<sup>68</sup> NRECA letter at 13, SIFMA/ISDA letter at 4, ISDA letter at 4, AIMA letter at 2 and AMG letter at 7.

<sup>69</sup> SIFMA/ISDA letter at 4. See also ISDA letter at 4.

## 6. Power to Change Election With Regard to Segregation

In the NPRM, the Commission proposed regulation 23.601(f),<sup>70</sup> which makes clear that a counterparty's election with respect to the segregation of initial margin may be changed at the discretion of the counterparty upon delivery of written notice, and such decision shall be applicable with respect to swaps entered into between the parties after such delivery. Rather than grant the counterparty an absolute right to change its election, the Working Group recommended that the counterparty must expressly reserve such right: “[if] a party makes an election under the Proposed Rule and does not expressly reserve the right to change that election in the relevant swap trading relationship documentation, then they cannot do so.”<sup>71</sup>

The Commission does not believe that the commenter's clarification is appropriate. The Commission notes that the rule clearly states that any change to the counterparty's segregation election would only apply to “swaps entered into between the parties after ... delivery” of written notice to the SD or MSP. Therefore, if a counterparty sought to change its segregation election, such election would not have retroactive effect (unless both the counterparty and the SD or MSP so agreed). In other words, the proposed rule leaves changes in terms for pre-existing swaps – including with respect to segregation of collateral – as matters for negotiation between the parties. The counterparty should retain its rights, under the statute, to change its election as to swaps entered into after the notice is delivered. As such, the Commission is adopting the final rule language as proposed.

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<sup>70</sup> Proposed regulation 23.601(f) is being finalized herein as regulation 23.701(f).

<sup>71</sup> Working Group letter at 5.

## C. Regulation 23.702: Requirements For Segregated Margin

### 1. Independent Custodian and Separate Account

Pursuant to section 4s(1)(3) of the CEA, the Commission proposed regulation 23.602(a)(1),<sup>72</sup> which required that initial margin, segregated in accordance with an election under regulation 23.601, be held with a custodian that is independent of both the SD or MSP and the counterparty. Proposed regulation 23.602(a)(2)<sup>73</sup> required such initial margin to be held in an account designated as a segregated account for and on behalf of the counterparty.<sup>74</sup> While, as noted, the right to segregation does not apply to variation margin, the proposed regulation provided that the SD or MSP and the counterparty may agree that collateral falling within the definition of variation margin may also be held in such segregated account. The Commission requested comment on, among other things, whether an affiliate of the SD, MSP or the counterparty should be considered an independent custodian. In addition, the Commission requested comment on whether either party could choose a custodian and, if so, what restrictions, if any, should be placed on that choice.

Fourteen commenters discussed the choice of custodian for segregation.<sup>75</sup> The topics discussed by commenters included the freedom of negotiation between the SD or MSP and counterparty, the use of a custodian affiliated with an SD or MSP, the right of the counterparty to choose the custodian, and qualifying criteria for a custodian.

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<sup>72</sup> Proposed regulation 23.602(a)(1) is being finalized herein as regulation 23.702(a).

<sup>73</sup> Proposed regulation 23.602(a)(2) is being finalized herein as regulation 23.702(b).

<sup>74</sup> See discussion in section A.1 supra.

<sup>75</sup> MFA, SIFMA/ISDA, ISDA, ICI, Working Group, NRECA, AMG, MetLife, EEI, Fidelity, AIMA, FHLB, Norges, State Street.

Four commenters argued that the custodian should be determined purely by negotiation between the counterparty and SD or MSP. ICI opined that “the choice of custodian should be left to the agreement of the parties.”<sup>76</sup> AIMA wrote that “[t]he parties should be free to negotiate which custodian is used, and it may be useful for the [SD] or MSP to let the customer know which custodians it has relationships with and has conducted appropriate due diligence on, including affiliates and non-affiliates, and thus its preferred choices of custodian.”<sup>77</sup> Similarly, the Working Group suggested “that outside the election to segregate collateral, which is the right of a [SD’s or MSP’s] counterparty, all other terms and parameters of a custodial relationship should be left to negotiation between counterparties....”<sup>78</sup> The NRECA wrote that it “see[s] no benefit to the Commission making [the choice of custodian] by regulation, rather than leaving them to arm’s length negotiations between contract counterparties.”<sup>79</sup>

However, AMG stated that while both the counterparty and the SD or MSP have an interest in the selection of the custodian, the counterparty is likely the party with the greatest interest and should therefore have the right to select the custodian.<sup>80</sup>

Several commenters discussed whether an affiliate of the SD or MSP would qualify as an independent custodian. MetLife suggested “that a custodial arrangement with an affiliate of the SD or MSP would satisfy the requirements for the use of an Independent Custodian....”<sup>81</sup> AMG wrote that “the CFTC should not limit the choice of

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<sup>76</sup> ICI letter at 3-4.

<sup>77</sup> AIMA letter at 2.

<sup>78</sup> Working Group letter at 2.

<sup>79</sup> NRECA letter at 14.

<sup>80</sup> AMG letter at 3.

<sup>81</sup> MetLife letter at 2.

custodian solely to those unaffiliated with the relevant SD/MSPs and Customer Counterparties but should provide the flexibility to use a custodian who may also be affiliated with any SD/MSP or Customer Counterparty.”<sup>82</sup> Fidelity expressed concern that an “unintended and undesirable consequence of banning affiliates from acting as third-party custodians could be to prevent counterparties from entering into swaps with [SD/MSPs], where an affiliate of the [SD/MSP] already serves as a depository or custodian of the counterparty.”<sup>83</sup>

Other commenters were receptive to the idea of an affiliate custodian, but advised that the SD or MSP should be required to present options to the counterparty on this issue. For example, AIMA recommended that the Commission require SDs and MSPs to “offer a choice of ... five custodians on whom they have conducted [a] due diligence examination, including both an affiliate (if applicable) and a non-affiliate.”<sup>84</sup> Similarly, FHLB urged the Commission to condition allowing an affiliate of the SD or MSP to act as custodian upon mutual agreement of the counterparty and the SD or MSP, and suggested that “the SD/MSP [should be] required to offer segregation with at least one non-affiliated custodian.”<sup>85</sup> SIFMA/ISDA wrote that an SD or MSP “should be required, upon counterparty request, to propose at least one creditworthy non-affiliated custodian that the SD/MSP is willing to use, as an option.”<sup>86</sup> AMG noted that the regulations

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<sup>82</sup> AMG letter at 2. See also MFA letter at 3-4, EEI letter at 2.

<sup>83</sup> Fidelity letter at 5.

<sup>84</sup> AIMA letter at 2.

<sup>85</sup> FHLB letter at 8.

<sup>86</sup> SIFMA/ISDA letter at 5. See also ISDA letter at 7.

should be flexible enough to allow the use of a custodian affiliated with an SD, MSP, or the counterparty.<sup>87</sup>

Three other commenters suggested that counterparties should have the right to designate a non-affiliate custodian. State Street recommended that the proposed rules be revised to provide that a “counterparty has the right to designate the independent custodian, if that custodian is a U.S. bank ... and otherwise serves as a usual depository for assets of the counterparty.”<sup>88</sup> Fidelity wrote that while affiliates of the SD or MSP can be appropriate custodians, “a counterparty should have the right to require that a third-party custodian be independent from the [SD or MSP].”<sup>89</sup> Norges proposed that the final rule should provide the “non-dealer/MSP counterparties the option to require that initial margin ... be held with a custodian that is in fact independent of any affiliate of the swap dealer or MSP.”<sup>90</sup>

Two commenters offered qualifying criteria for a custodian. The MFA suggested that a custodian ought to be “regulated by a federal or state bank regulator, be authorized under federal or state laws to exercise corporate trust powers, and have equity of at least [\$200 million].”<sup>91</sup> MetLife suggested that an affiliate custodian could satisfy the requirements for an independent custodian where it, inter alia, “maintains a minimum asset value [of at least \$2 billion] under custodial management.”<sup>92</sup>

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<sup>87</sup> AMG letter at 2.

<sup>88</sup> State Street letter at 2.

<sup>89</sup> Fidelity letter at 5. See also FHLB letter at 8, recommending that if parties cannot agree on a custodian then the counterparty should be able to designate the custodian.

<sup>90</sup> Norges letter at 2.

<sup>91</sup> MFA letter at 4.

<sup>92</sup> MetLife letter at 2.

The Commission also received one comment regarding the timing of the requirement to segregate. SIFMA/ISDA requested that, due to the amount of time required to fully negotiate a custodial arrangement, parties “be permitted to enter into new swaps pending completion of custodial documentation satisfactory to both parties for so long as the parties are negotiating in good faith to complete such custodial documentation.”<sup>93</sup> SIFMA/ISDA also argued that the requirement to segregate the initial margin “with respect to all swaps entered into after delivery of an election to require segregation... unless otherwise agreed, become effective only upon the completion of custodial documentation.”<sup>94</sup>

The language of the statute does not require that affiliates of a counterparty be prohibited from serving as the custodian for segregated funds. Affiliates are third-parties in that they are separate legal entities, and therefore fall within the terms of the statute. However, in light of the correlated insolvency risk wherein if an SD or MSP becomes insolvent its affiliates will have an elevated risk of also becoming insolvent, the Commission has determined that an SD or MSP should be required to provide the counterparty with at least one credit worthy non-affiliate as an option to serve as the custodian. The final rule text has been amended to incorporate the requirement that SDs and MSPs must provide their counterparties with at least one credit worthy non-affiliate as an option to serve as the custodian.<sup>95</sup>

Regarding SIFMA/ISDA’s question relating to the timing of segregation, waiting until the completion of custodial documentation for an election to require segregation to

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<sup>93</sup> SIFMA/ISDA letter at 5. See also ISDA letter at 5.

<sup>94</sup> SIFMA/ISDA letter at 5, ISDA letter at 5.

<sup>95</sup> See regulation 23.701(a)(2).

become effective would likely create difficulties where an insolvency occurs in the time period between agreement and documentation. Thus, it is the Commission's position that protection of initial margin is best achieved by requiring customer segregation to become effective upon election, not upon completion of custodial documentation. In addition, the Commission notes that compliance with SIFMA/ISDA's suggested "good faith" requirement would be impracticable to assess and is not amending the rule as suggested.

## 2. Requirements for Custody Agreement

In the NPRM, the Commission proposed regulation 23.602(b),<sup>96</sup> which imposed certain requirements on agreements for the segregation of margin. Regulation 23.602(b) was intended to provide a balance between the minimum interests of (i) the counterparty posting the margin, (ii) the SD or MSP for whom the margin is posted, and (iii) the custodian, while avoiding the necessity for time-consuming and expensive interpleader proceedings.<sup>97</sup> Under the proposal, an agreement for the segregation of margin would have to be in writing, and must include the custodian as a party. In addition, to ensure that the SD or MSP receives the margin promptly in case it is entitled to do so, and that the margin is returned to the counterparty in case it is entitled to such return, the agreement must also provide that turnover of control shall be made promptly upon presentation of a statement in writing, signed by an authorized person under penalty of perjury, that one party is entitled to such turnover pursuant to an agreement between the parties.<sup>98</sup> Otherwise, withdrawal of collateral may only be made pursuant to the

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<sup>96</sup> Proposed regulation 23.602(b) is being finalized herein as regulation 23.702(c).

<sup>97</sup> If the SD or MSP and the counterparty were to make competing claims to the collateral, and if the custodian did not have a means under the agreement among the parties to decide between such claims without risking legal liability, the custodian would likely choose to interplead the collateral.

<sup>98</sup> See 28 U.S.C. 1746. See also 18 U.S.C. 1621 (Perjury Generally).

agreement of both the counterparty and the SD or MSP, with the non-withdrawing party also receiving immediate notice of such withdrawal.<sup>99</sup>

Nine commenters argued against imposing a perjury standard on any written statements by either the counterparty or the SD or MSP informing the custodian to turn over of control of margin.<sup>100</sup> For example, ICI wrote that it “believe[s] that it is unnecessary to introduce the specter of criminal prosecution into custodial account documentation....”<sup>101</sup>

The Commission believes that a perjury standard is appropriate because it mitigates the tradeoff between speed and accuracy in stress situations. In circumstances where one party to a swap needs expedient turnover of segregated margin (for example, in order to meet margin calls on positions hedging the swap) and is unable to obtain timely approval from the counterparty (e.g., if margin is being taken from the account because the counterparty is in financial trouble), it is important for a depository to be able to respond to a unilateral request for collateral without having to take the time to independently investigate the legitimacy of the request.<sup>102</sup> At the same time, circumstances of market stress may also create incentives for parties to illegitimately

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<sup>99</sup> The importance of taking steps to ensure that unauthorized withdrawals are not made is enhanced by the findings of the Commission’s Division of Clearing and Intermediary Oversight in Financial and Segregation Interpretation 10-1, 20 FR 24768, 24770 (May 11, 2005) (“Findings by both Commission audit staff and the SROs of actual releases of customer funds [from third-party custodial accounts], without the required knowledge or approval of the FCMs, further demonstrate that the risks associated with third-party custodial accounts are real and material, not merely theoretical.”).

<sup>100</sup> ICI, Working Group, AMG, Fidelity, SIFMA/ISDA, MFA, ISDA, FHLB, MetLife.

<sup>101</sup> ICI letter at 4. See also Working Group letter at 4, AMG letter at 6, Fidelity letter at 4-5, SIFMA/ISDA letter at 6, MFA letter at 5, ISDA letter at 7, MetLife letter at 2.

<sup>102</sup> In times of significant market stress, any unnecessary impediments or restrictions on a counterparty’s ability to obtain immediate access to posted margin when such access is legitimate could impair the operations of the counterparty, impair the liquidity of other market participants and magnify the impact of a market disruption.

withdraw collateral from a segregated account.<sup>103</sup> The perjury standard acts as a check on the legitimacy of a demand for collateral without requiring the time needed for an independent inquiry by the depository. At the same time, an SD, MSP or counterparty making a demand for collateral can avoid criminal liability if it does not engage in purposeful fraud.

The Commission has decided to adopt the rule substantively as proposed. However, the Commission points out that it has re-organized the rule and modified certain language to provide greater clarity. Specifically, the Commission combined the language in paragraphs (a) and (a)(1) into paragraph (a). The Commission also renumbered paragraph (a)(2) as paragraph (b). The Commission then renumbered paragraph (b) as paragraph (c) and switched the text in subparagraphs (1) and (2). The Commission also added clarifying language to paragraphs (a),(b) and (c) to facilitate this reorganization.

#### D. Regulation 23.703: Investment of Segregated Margin

##### 1. Limitations on Investments

Proposed regulation 22.603(a)<sup>104</sup> provides that segregated initial margin may only be invested consistent with the standards for investment of customer funds that the Commission applies to exchange-traded futures and cleared swaps, regulation 1.25.<sup>105</sup>

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<sup>103</sup> A party facing insolvency or fearing imminent insolvency on the part of its counterparty might be tempted to demand transfer of margin without fully ensuring they were entitled to it, to take the margin without plans to return it, or take the margin for the purpose of covering an unrelated debt in the expectation of saving their business and returning the margin shortly thereafter.

<sup>104</sup> Proposed regulation 23.603(a) is being finalized herein as regulation 23.703(a).

<sup>105</sup> Section 4s(1)(2)(B)(ii)(I) of the CEA refers to “commercial arrangements regarding the investment of segregated funds or other property that may only be invested in such investments as the Commission may permit by rule or regulation.”

Eight commenters expressed the view that imposing the standards of regulation 1.25 on the investment of collateral for uncleared swaps was overly restrictive.<sup>106</sup>

Fidelity suggested that “custodians under tri-party custody arrangements may limit the types of collateral that it will permit under such arrangements to those investments permitted pursuant to [regulation] 1.25.”<sup>107</sup> Fidelity further proposed that the Commission require not only segregation of initial margin but also variation margin, explaining that “the right to require segregation of variation margin ... would reduce systemic risk for the same reasons that segregation of initial margin reduces systemic risk.”<sup>108</sup> Similarly, AMG argued that the Commission should “confirm the right of Customer Counterparties to require segregation of both initial margin and variation margin,” explaining that the current practice in the OTC market is to require all collateral to be segregated and held by a third-party custodian.<sup>109</sup>

MetLife wrote that such a restriction is “outside the scope of normal market practice” and that counterparties “should be able to negotiate the terms for investment of Initial Margin consisting of cash within [their] own established investment guidelines.”<sup>110</sup> FHLB added that “Congress appropriately did not seek to limit how margin for uncleared swaps would be invested,” asserting that Congress had assumed that “both the end-user counterparty and the SD/MSP would necessarily be involved in the decision as to how

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<sup>106</sup> MetLife, Federated, ICI, AMG, Fidelity, SIFMA/ISDA, ISDA, FHLB.

<sup>107</sup> Fidelity letter at 5-6.

<sup>108</sup> Fidelity letter at 4.

<sup>109</sup> AMG letter at 6.

<sup>110</sup> MetLife letter at 3. See also Federated letter at 3-7, ICI letter at 4-6, AMG letter at 3-5, Fidelity letter at 5-6, SIFMA/ISDA letter at 6, ISDA letter at 8, FHLB letter at 12.

such funds would be invested.”<sup>111</sup> Federated warned that this proposal will cause a loss of investment returns.<sup>112</sup>

In contrast, AIMA wrote that “[t]he requirements of Regulation 1.25 of the CFTC Regulations ... likely strike[] the right balance between flexibility and the protection of the value of the collateral.”<sup>113</sup>

Regulation 1.25 establishes a general prudential standard used in the futures and cleared swaps markets that requires all permitted investments of customer segregated funds to be consistent with the objectives of preserving principal and maintaining liquidity.<sup>114</sup> As stated by the Commission in regulation 1.25’s adopting release, “[i]n finalizing amendments to Regulation 1.25, the Commission seeks to impose requirements on the investment of customer segregated funds with the goal of enhancing the preservation of principal and maintenance of liquidity consistent with Section 4d of the Act.”

Similarly, the Commission believes that applying the requirements of regulation 1.25 to uncleared swaps will increase the safety and maintain the liquidity of counterparty funds held by the custodian. Regulation 1.25 establishes a general prudential standard by requiring that all permitted investments be “consistent with the objectives of preserving principal and maintaining liquidity.”<sup>115</sup> While such a standard may lead to lower investment returns, lower investment returns correlate to decreased investment risk and must be viewed in the context of the importance of protecting counterparties’ collateral

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<sup>111</sup> FHLB letter at 13.

<sup>112</sup> Federated letter at 7, 11.

<sup>113</sup> AIMA letter at 3.

<sup>114</sup> See Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 FR 78776 (Dec. 19, 2011).

<sup>115</sup> Id. at 78776.

and mitigating systemic risk that could result from the loss of access to such collateral and, in turn, adversely impact the stability of the U.S. financial markets. After considering the comments, the Commission has decided to adopt the rule as proposed. The Commission believes that the rule achieves the appropriate balance between the goals of protecting counterparties' collateral and mitigating systemic risk, on the one hand, and the goals of retaining an appropriate degree of investment flexibility and opportunities for attaining capital efficiency for DCOs and FCMs investing customer segregated funds, on the other hand."<sup>116</sup>

It should be noted that § 23.703(a) only restricts the manner in which an SD or MSP may invest margin that is segregated pursuant to an election under § 23.701. This rule does not in any way restrict the types of collateral that a counterparty may post to an SD or MSP, nor does it require an SD or MSP to convert, in any way, posted collateral.<sup>117</sup>

In addition, as discussed above, the Commission notes that requiring the segregation of variation margin would be beyond the scope of section 4s(l) of the statute and what Congress prescribed therein.<sup>118</sup> However, the Commission believes that it would be consistent with that statute to allow the parties to agree to have segregation arrangements for variation margin. Moreover, the Commission acknowledges that where a counterparty and its SD or MSP have agreed to segregate both initial margin and variation margin, such margin may be commingled and held in the same account. But, to the extent that the parties agree to commingle segregated initial and variation margin, the

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<sup>116</sup> Id. at 78778.

<sup>117</sup> But cf. Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011) (proposing to limit the forms of acceptable initial margin to a specified list of eligible collateral for transactions between a swap dealer or major swap participant for which there is no prudential regulator and a counterparty that is a swap dealer, a major swap participant or a financial entity).

<sup>118</sup> See discussion in section B.2 supra.

Commission clarifies that the requirements set forth in Subpart L to this Part 23, including the investment restrictions in regulation 23.703(a), would apply to all margin held (both initial margin and variation margin) in such account.

## 2. Commercial Arrangements Regarding Investments and Allocations

As required by section 4s(l)(2)(B)(ii) of the CEA and subject to the limitations set forth in regulation 23.603(a), proposed regulation 22.603(b) provided that the SD or MSP and the counterparty may enter into any written commercial arrangement regarding the terms of the investment of segregated margin and the related allocation of gains and losses resulting from such investment. The Commission is adopting this aspect of the rule as proposed.<sup>119</sup>

### E. Regulation 23.704: Requirements for Non-Segregated Margin

Section 4s(l)(4) of the CEA mandates that, if the counterparty does not choose to require segregation, the SD or MSP shall report to the counterparty, on a quarterly basis, “that the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements are in compliance with the agreement of the counterparties.”<sup>120</sup> Proposed regulation 23.604(a)<sup>121</sup> implemented this provision and required that such reports be made no later than the fifteenth (15<sup>th</sup>) business day of each calendar quarter for the preceding calendar quarter. Proposed regulation 23.604(a) made the Chief Compliance Officer of the SD or MSP responsible for such report. In addition, proposed regulation 23.604(b) provided that this obligation shall apply no earlier than the

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<sup>119</sup> Proposed regulation 23.603(b) is being finalized herein as regulation 23.703(b).

<sup>120</sup> 7 U.S.C. 6s(l)(4).

<sup>121</sup> Proposed regulation 23.604 is being finalized herein as regulation 23.704.

90<sup>th</sup> calendar day after the date on which the first swap is transacted between the counterparties.

Four commenters discussed this proposal.<sup>122</sup> The Working Group wrote that quarterly report of back office compliance for swaps with non-segregated margin is unnecessarily burdensome.<sup>123</sup> SIFMA and ISDA also argued that the requirement for a Chief Compliance Officer statement would be burdensome.<sup>124</sup>

SIFMA and ISDA went further, suggesting that disclosure should not be required especially where the relevant SD/MSP is permitted to freely sell, pledge, rehypothecate, assign, invest, use, commingle, or otherwise dispose of any independent amount that it holds, since any such disclosure would be meaningless.<sup>125</sup>

The Working Group argued that an initial representation as to compliance should be treated as renewed each quarter unless altered by the SD or MSP.<sup>126</sup> SIFMA and ISDA proposed giving the counterparty permission to waive receipt of the quarterly disclosure.<sup>127</sup>

The Working Group also suggested that in addition to forgoing or electing segregation under the rule, parties may choose to segregate outside of the proposed rule.<sup>128</sup> For example, the Working Group stated that a counterparty may wish to have its

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<sup>122</sup> Working Group, AIMA, ISDA and SIFMA/ISDA.

<sup>123</sup> Working Group letter at 5-6. See also SIFMA/ISDA letter at 7 and ISDA letter at 8.

<sup>124</sup> SIFMA/ISDA letter at 7 and ISDA letter at 9.

<sup>125</sup> SIFMA/ISDA letter at 7 and ISDA letter at 8.

<sup>126</sup> Working Group letter at 6.

<sup>127</sup> SIFMA/ISDA letter at 7 and ISDA letter at 8.

<sup>128</sup> Working Group letter at 3.

collateral held in an SD's omnibus customer account, and that such agreements should be permitted.<sup>129</sup>

By contrast AIMA agreed with the proposal for reporting on a regular basis and suggested that reporting also occur immediately following entry of a swap agreement.<sup>130</sup>

While quarterly reporting may impose certain administrative burdens on SDs and MSPs, such quarterly reporting, as contemplated by regulation 23.704, is expressly required by the statute.<sup>131</sup> The Commission agrees that since a counterparty may choose not to segregate at all, it also may elect to segregate in some lesser manner than that contemplated by regulation 23.702. However, the Commission notes that, for counterparties who do not choose segregation, as contemplated by section 4s(l)(1)(B) of the CEA, the purpose of section 4s(l)(4) of the CEA is to confirm that the SD or MSP is adhering to the obligations of their agreement. Therefore, the requirements of regulation 23.704 will apply to all agreements relating to uncleared swaps for which the counterparty does not elect to segregate initial margin pursuant to regulation 23.702. Moreover, the Commission believes that placing responsibility for the report with the chief compliance officer of the SD or MSP required by Section 4s(k) of the CEA is appropriate in light of the chief compliance officer's role in making sure the SD or MSP

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<sup>129</sup> Id.

<sup>130</sup> AIMA letter at 3.

<sup>131</sup> The reporting requirement found in section 4s(l)(4) of the CEA states that if the counterparty does not choose to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty, the swap dealer or major swap participant shall report to the counterparty of the swap dealer or major swap participant on a quarterly basis that the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements are in compliance with the agreement of the counterparties.

complies with its statutory and regulatory obligations.<sup>132</sup> The Commission is adopting the rule as proposed.

#### F. Compliance Date

In the NPRM, the Commission requested comment on the appropriate timing of effectiveness for the final rules for Part 23. SIFMA/ISDA recommended a 6 month implementation period for swaps that are entered into with new counterparties and a 12 month implementation period for swaps that are entered into with existing counterparties.<sup>133</sup> The Working Group recommended a 12 month implementation period.<sup>134</sup> After consideration of the comments, the Commission has decided to adopt SIFMA/ISDA's suggestion, which would provide a 6 month implementation period for swaps that are entered into with "new counterparties" and a 12 month implementation period for swaps that are entered into with "existing counterparties."

### **III. Portfolio Margining**

The NRPM proposed changes to the definition of "customer" in § 190.01(k)<sup>135</sup> and the definition of "customer property" in § 190.08(a)(1)(i)(F)<sup>136</sup> to implement section 713(c) of the Dodd-Frank Act, which added section 20(c) of the CEA and stated that the Commission "shall exercise its authority to ensure that securities held in a portfolio

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<sup>132</sup> See generally section 4s(k)(2)(E) of the CEA (stating that the chief compliance officer shall "ensure compliance with the [CEA] (including regulations) relating to swaps, including each rule prescribed by the Commission under [section 4s].")

<sup>133</sup> SIFMA/ISDA letter at 8. See also ISDA letter at 9.

<sup>134</sup> Working Group letter at 7. See also ICI letter at 6.

<sup>135</sup> The Commission proposed to define "customer" as follows: "Customer shall have the same meaning as that set forth in section 761(9) of the Bankruptcy Code. To the extent not otherwise included, customer shall include the owner of a portfolio margining account carried as a futures account."

<sup>136</sup> The Commission proposed to include "To the extent not otherwise included, securities held in a portfolio margining account carried as a futures account" in the definition of "customer property." 75 FR at 75435 (Dec. 10, 2010).

marginining account carried as a futures account are customer property and the owners of those accounts are customers for the purposes of” subchapter IV of chapter 7 of the U.S. Bankruptcy Code.

The Commission received three comments on these proposals.<sup>137</sup> ICE agreed with the proposed amendments to the definition of “customer” and “customer property” stating that the proposal was “a necessary step toward realizing the important benefits of portfolio margining for market participants.”<sup>138</sup> ICE also expressed concern that the reference to “futures account” while excluding swaps referred to in 4d(f) of the CEA would “create artificial and unnecessary distinctions between futures and other products regulated by the Commission,”<sup>139</sup> and would detract from the “certainty for the treatment in insolvency of portfolio margining arrangements that include both swaps and securities.”<sup>140</sup> As such, ICE requested a technical clarification to make clear that the treatment in insolvency of portfolio margining arrangements includes arrangements involving swaps.<sup>141</sup> AIMA also indicated its approval of the proposed amendments to the definition of “customer” and “customer property,”<sup>142</sup> and ICI supported the proposed amendment as an implementation of section 713(c) of the Dodd-Frank Act.<sup>143</sup>

After careful consideration of the comments, the Commission agrees that Congress, in directing the Commission to clarify the treatment of “securities” held in a “futures account,” did not mean to imply that securities held in a Cleared Swaps

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<sup>137</sup> ICE, AIMA, ICI.

<sup>138</sup> ICE letter at 2.

<sup>139</sup> *Id.* at 3.

<sup>140</sup> *Id.* at 2.

<sup>141</sup> *Id.* at 2.

<sup>142</sup> AIMA letter at 3.

<sup>143</sup> ICI letter at 6-7.

Customer Account would not be treated as customer property. Accordingly, the Commission will adopt a technical clarification, as suggested by ICE's comments, to avoid the implication that portfolio margining arrangements involving swaps do not receive the same bankruptcy protection as portfolio margining arrangements involving futures. Thus, where the Commission has referred to a "futures account" in the definition of "customer" in § 190.01(k) and the definition of "customer property" in § 190.08(a)(1)(i)(F), the Commission is adding a reference to a "Cleared Swaps Customer Account." The Commission is otherwise adopting these changes as proposed.

The Commission also proposed certain technical corrections to sections 190.02 and 190.06. The Commission notes, however, that substantively identical technical corrections were completed in a prior rulemaking, and thus no further action is necessary in this regard herein.<sup>144</sup>

#### **IV. Related Matters**

##### **A. Regulatory Flexibility Act**

The Regulatory Flexibility Act ("RFA") requires Federal agencies to consider the impact of its rules on "small entities."<sup>145</sup> A regulatory flexibility analysis or certification typically is required for "any rule for which the agency publishes a general notice of proposed rulemaking pursuant to" the notice-and-comment provisions of the Administrative Procedure Act, 5 U.S.C. 553(b).<sup>146</sup>

With respect to the proposed release, while the Commission provided an RFA statement that the proposed rule would impose regulatory obligations on SDs and MSPs

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<sup>144</sup> See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 FR 6336 (Feb. 7, 2012).

<sup>145</sup> 5 U.S.C. 601 et seq.

<sup>146</sup> 5 U.S.C. 601(2), 603, 604 and 605.

and noted that SDs and MSPs were new categories of registrants, the Commission determined that the SDs and MSPs were like FCMs and large traders that have been determined not to be small entities.<sup>147</sup> Thus, in the proposal, the Commission certified that the rulemaking would not have a significant economic effect on a substantial number of small entities. Comments on that certification were sought.

As indicated in the NPRM, the final rule will impose regulatory obligations on SDs and MSPs. The conclusion that the rule will not have a significant economic impact on a substantial number of small entities within the meaning of the RFA remains valid for the final rule, which like the proposed rule, imposes duties only on SDs and MSPs. Subsequent to the publication of the NPRM for this rule, the Commission has determined in other rulemakings that SDs and MSPs should not be considered small entities based on their size and characteristics analogous to non-small entities that pre-dated the adoption of the Dodd-Frank Act and has certified that these entities are not small entities for RFA purposes.<sup>148</sup> As stated in prior rules, because of the SDs and MSPs size and characteristics and the “de minimis” requirements, SDs and MSPs should not be considered small entities for purposes of the RFA and SBA regulations.<sup>149</sup> Nevertheless, in the “entities” rule that further defined the terms SD and MSP, supplementing the

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<sup>147</sup> 75 FR 75432, 75435-36 (Dec. 3, 2010).

<sup>148</sup> See 77 FR 48208, 48306 (Aug. 13, 2012); Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, citing 76 FR 29868 – 29869 (May 23, 2011). See also, Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128, 20193 (Apr. 3, 2012); Registration of Swap Dealers and Major Swap Participants, 77 FR 2613, 2620 (Jan. 19, 2012), citing 75 FR 71379, 71385 (Nov. 23, 2010) (Registration of Swap Dealers and Major Swap Participants).

<sup>149</sup> The Small Business Administration (“SBA”) identifies (by North American Industry Classification System codes) a small business size standard of \$7 million or less in annual receipts for Subsector 523—Securities, Commodity Contracts, and Other Financial Investments and Related Activities. 13 CFR 121.201 (1–11 Edition). 65 FR 30840 (May 15, 2000).

statutory definitions of those terms, the Commission expected that if any small entity were to engage in the activities covered by the definition, most such entities would be eligible for the “de minimis” exception from the definition.<sup>150</sup> Also, the Commission noted that the MSP participant definition applies only to persons with very large swap positions, and therefore the definition of MSP is incompatible with small entity status.<sup>151</sup> Thus, the “entities” final rule concluded that the rule, insofar as it affected SDs and MSPs, would not have a significant economic impact on a substantial number of small entities.<sup>152</sup> The same reasoning applies to the present rule.

One commenter, representing a number of market participants in the energy business, submitted a comment related to the RFA, stating that “[e]ach of the complex and interrelated regulations currently being proposed by the Commission has both an individual, and a cumulative, effect on . . . small entities.”<sup>153</sup> Upon consideration of this commenter’s statements, the CFTC notes that it is not required to consider the cumulative economic impact of the entire mosaic of rules under the Dodd-Frank Act, since an agency is only required to consider the impact of how it exercises its discretion to implement the statute through a particular rule. In all rulemakings, the Commission performs an RFA analysis for that particular rule. The observations of this commenter therefore do not provide a reason to conclude that the rules being promulgated in this rulemaking will have a significant economic impact on a substantial number of small entities within the

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<sup>150</sup> Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant” and “Eligible Contract Participant,” 77 FR 30596, 30701 (May 23, 2012).

<sup>151</sup> See id.

<sup>152</sup> 77 FR at 30701 (May 23, 2012). See also “Registration of Swap Dealers and Major Swap Participants,” 77 FR 2613, 2620 (Jan. 19, 2012) (“Registration Adopting Release”) (“In terms of affecting a substantial number of small entities . . . the Commission is statutorily required to exempt from designation as an SD those entities that engage in a de minimis quantity of swaps dealing.”).

<sup>153</sup> NRECA letter at 16.

legal meaning of the RFA. This is so because, as explained above, the rules in question impose duties only on SDs and MSPs and not on other entities, small or otherwise.

Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the final rules will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

1. Introduction

Provisions of new regulation Part 23, specifically regulations 23.701 and 23.704, include information disclosure requirements that constitute the collection of information within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>154</sup> The Commission therefore has submitted this collection of information to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. Under the PRA, an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.<sup>155</sup> The title for this collection of information is “Disclosure and Retention of Certain Information Relating to Swaps Customer Collateral,” OMB Control Number 3038-0075, which has been submitted to OMB for approval. The collection of information will be mandatory. The information in question will be held by private entities and, to the extent it involves consumer financial information, may be protected under Title V of the Gramm-Leach-Bliley Act as amended by the Dodd-Frank Act.<sup>156</sup> An

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<sup>154</sup> 44 U.S.C. 3501 et seq.

<sup>155</sup> Id.

<sup>156</sup> See generally Notice of Proposed Rulemaking, Privacy of Consumer Financial Information; Conforming Amendments Under Dodd-Frank Act 75 FR 66014 (Oct. 27, 2010).

agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

## 2. Comments Received on Collection of Information Proposed in NPRM

Estimates of the expected information collection burden related to regulations 23.701 and 23.704 were published for comment in the NPRM.<sup>157</sup> General comments on these regulations and the Commission's response are discussed in a previous section of this preamble. The Commission received two comments specifically addressing the Commission's numerical PRA burden estimate for regulation 23.701.<sup>158</sup> A comment from ISDA stated that the annual burden estimate of 0.3 hours per counterparty for this requirement appeared insufficient. The comment stated:

Specifically, the following documentation-related functions would be necessary: scheduling, drafting, issuing, tracking, receipt, validation, classification and storage. As a result, we believe that the process contemplated by the Proposed Rules would entail multiple hours of staff time per counterparty.<sup>159</sup>

The second comment made substantially the same point.<sup>160</sup> In response to these comments, and certain other considerations, the Commission has reevaluated the per-disclosure burden estimate for regulation 23.701 and has modified the estimate as discussed below.

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<sup>157</sup> In the NPRM these provisions were numbered as regulation 23.601 and 23.604.

<sup>158</sup> The comments referred to regulation 23.601, reflecting the numbering in the NPRM.

<sup>159</sup> ISDA letter at 5.

<sup>160</sup> SIFMA/ISDA letter at 4.

3. Adjustments to Estimate of Information Collection Burden Based on New Estimate of Expected Total Number of Swap Dealers and Major Swap Participants

The Commission has determined to adjust the burden estimate for Regulations 23.701 and 23.704 based on a number of considerations. Both regulations apply to SDs and MSPs. At the time the NPRM was published, it was estimated, for purposes of the PRA burden estimate, that the total number of SDs and MSPs would be about 300 entities. Based on information developed since that time, the Commission now estimates that the total number of SDs and MSPs, and thus the total number of entities required to engage in information collection pursuant to these rules, will be about 125 entities.<sup>161</sup>

For the disclosure required by regulation 23.701 the Commission is also adjusting its estimate of the per disclosure burden, for a number of reasons. First, the final regulation requires that the disclosure (a) identify one or more custodians for segregated initial margin acceptable to the SD or MSP, at least one of which must be legally independent of the parties to the transactions and (b) provide information on the price of segregation for each identified custodian to the extent that the SD or MSP has such information. As a result of these changes, it is expected that part of the disclosure required by the regulation will be standardized, with accompanying efficiencies in drafting and making disclosure, but that part of the disclosure may be specific to particular transactions. Second, as noted above, commenters suggested that the burden estimate in the NPRM was insufficient to cover all of the tasks necessary to make the required disclosure.

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<sup>161</sup> See discussion in Registration of Swap Dealers and Major Swap Participants, 77 FR 2613, 2622 (Jan. 19, 2012).

In the NPRM, the Commission estimated that disclosure required by regulation 23.701 would require 0.3 hours of work per disclosure, which could be performed by staff with a salary level of approximately \$20 per hour. The Commission has adjusted this time estimate to 2 hours per disclosure based on the considerations discussed immediately above. The Commission further estimates that the average dollar cost of the disclosure per hour will be \$50, giving a cost of \$100 for 2 hours of work.<sup>162</sup> In addition, for purposes of the NPRM, the Commission estimated that each SD and MSP would make the disclosure once per year to an average of between 433 and 666 counterparties.<sup>163</sup> The Commission is adjusting the estimate of number of disclosures per SD or MSP per year based on the reduction, noted above, in the estimate of the total number of SDs and MSPs from about 300 to about 125. Assuming a roughly similar total number of counterparties will be doing business with SDs and MSPs, this implies that the number of counterparties doing business with each individual SD or MSP in a year will probably be higher on average than was estimated at the time of the NPRM. To account for this likely effect, the Commission now estimates that each SD and MSP will, on average, make the disclosure to approximately 1300 counterparties each year. As at the time of the NPRM, the Commission expects that the number of counterparties per SD or MSP per year is likely to be considerably higher than this average figure for the largest

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<sup>162</sup> This estimate is based on the assumption that about three quarters of the work will be done by junior level staff with a salary of approximately \$25 per hour and that about one quarter of the work will be done by senior level staff with a salary of approximately \$100 per hour. Compare SIFMA, Report on Management and Professional Earnings in the Securities Industry-2011 at 4 (national average total compensation for a junior level compliance specialist in the survey equaled \$50,998 per year, an hourly equivalent of approximately \$25), 8 (national average total compensation for a compliance attorney in the survey equaled \$131,304 per year, an hourly equivalent of approximately \$65).

<sup>163</sup> The estimate in the NPRM assumed that the largest SDs and MSPs would make the required disclosure to an average of 5,000-10,000 counterparties per year and that smaller SDs and MSPs would make the required disclosure to an average of about 200 counterparties per year. See 75 FR at 75436 (Dec. 3, 2010) and n. 29.

SDs and MSPs, and smaller than this average figure for some other SDs and MSPs.

Given the absence of experience with this newly promulgated rule, these estimates are subject to an inherent degree of uncertainty.

The Commission, in the NPRM, estimated that regulation 23.701 would require a total of approximately 130,000-200,000 disclosures per year, generating an estimated total annual information collection burden of approximately 40,000-60,000 hours and \$800,000-\$1,200,000. Based on the adjustments described above the Commission estimates that regulation 23.701 will require a total of approximately 162,500 disclosures per year, generating an estimated total annual information collection burden of approximately 325,000 hours and cost of \$16,250,000.

The Commission, in the NPRM, estimated that regulation 23.704 would require a total of approximately 260,000-400,000 disclosures per year, generating an estimated total annual information collection burden of approximately 80,000-120,000 hours and \$2,400,000-\$3,500,000.<sup>164</sup> The Commission is adjusting this estimate based on the reduced estimate of the number of affected SDs and MSPs from 300 to 125, and the increased estimate of 1300 counterparties per SD or MSP. In the absence of more specific information, the Commission continues to assume for purposes of this

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<sup>164</sup> This estimate in the NPRM was based on the requirement of regulation 23.704 that SDs and MSPs make the required disclosure four times each year to each of their uncleared swaps counterparties that does not choose to require segregation of initial margin. It was further based on estimates that each disclosure would require, on average, approximately 0.3 hours of staff time by staff with a salary level of approximately \$30 per hour although, per the terms of the rule, this would vary depending on the specifics of the agreement of the parties with regard to the back-office procedures of the SD or MSP and the extent to which such procedures were standardized. The estimate further assumed that about half of all uncleared swaps counterparties would not choose segregation of initial margin and that, as a result, the largest SDs and MSPs would make the required disclosure to an average of 2,500-5,000 counterparties four times per year and that smaller SDs and MSPs would make the required disclosure to an average of about 100 counterparties four times per year. See 75 FR at 75436 (Dec. 3, 2010) and n. 30; SIFMA, Report on Management and Professional Earnings in the Securities Industry-2011 at 4 (national average total compensation for a junior level compliance specialist in survey equaled \$50,998 per year, an hourly equivalent of approximately \$25).

calculation that half of counterparties will elect not to segregate, and will receive the required quarterly disclosure. The Commission notes that the cost per counterparty can be divided into two costs: an initial cost and an on-going, annual cost. In respect of the initial cost, the Commission estimates a total of twenty hours of the Chief Compliance Officer's time to prepare and design the SD or MSP's compliance procedures for its 23.704 disclosure requirements. In respect of ongoing costs, the Commission recognizes that, while the degree of disclosure to particular counterparties may differ (e.g., agreements may require no disclosure, high-level disclosure only or more in-depth disclosure), it is likely that the levels of disclosures may coalesce around certain intervals such that efficiencies may be observed in respect of analysis and preparation of current disclosures and ongoing updates to the same. The Commission estimates that the Chief Compliance Officer will spend five hours, on an annual basis, updating the existing procedures and reviewing compliance with such procedures as well as an additional hour, on a non-regular basis in perhaps 2% of the cases, addressing non-routine issues that may arise in respect of a particular disclosure to a counterparty. The Commission further estimates that a junior compliance officer will spend, on average, approximately 0.3 hours per counterparty on a quarterly basis, analyzing the procedures followed and preparing the disclosure to be sent.

Based on these adjustments, the Commission now estimates that regulation 23.704 will require initial costs of approximately \$280,000 and, on an ongoing basis, a total of approximately 325,000 disclosures per year generating an estimated total annual information collection burden of approximately \$3.7 million, based on the following: an annual cost of \$29,300 per SD/MSP comprising eighteen hours for the Chief Compliance

Officer with a salary level of approximately \$110.97 per hour and the annual cost of 780 hours for junior compliance staff with a salary level of approximately \$35 per hour, multiplied by an estimated 125 SD/MSPs.

C. Cost-Benefit Considerations

1. Background

Prior to the passage of the Dodd-Frank Act, the decision to segregate and the mechanics of such segregation were unregulated and left to the negotiation of the parties to the swap. Under new CEA section 4s(l)(1)(A), an SD or MSP is required to notify the counterparty of its right to segregation. Upon request by the counterparty, the SD or MSP must segregate the funds for the benefit of the counterparty, among other requirements under section 4s(l)(1)(B). Other paragraphs of section 4s(l) outline the applicability of the segregation notification, the nature of the custodian and the reporting requirement for unsegregated initial margin.

This legislative act is indicative of Congress's broad intent to increase the safety of the swaps market. While many aspects of Title VII of the Dodd-Frank Act promote the increased clearing of swaps, section 4s(l) indicates Congress' intent to increase the safety in the market for uncleared swaps by creating a self-effectuating requirement for the segregation of counterparty initial margin in an entity legally separate from the SD or MSP.

In the NPRM, the Commission invited the public "to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the proposal with their comment letters."<sup>165</sup> The Commission received no such quantitative

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<sup>165</sup> 75 FR at 75437 (Dec. 3, 2010).

data or information with respect to these rules. While the Commission did not receive comments directly on the costs and benefit analysis, it did receive comments that alluded to costs, as discussed in more detail in the sections below. For example, some commenters believed that the notification of counterparties of their right to segregation would create an administrative cost (although no commenters attempted to quantify such costs). FHLB, MetLife and EEI characterized transaction-by-transaction notification as repetitive and redundant.<sup>166</sup> Some commenters believed that even yearly notification was unnecessary.<sup>167</sup> On the topic of investing initial margin only as allowed under regulation 1.25, Federated directly stated that this would cause a loss of investment returns.<sup>168</sup> Finally, the Working Group wrote that requiring quarterly reporting for non-segregated margin would be unnecessarily burdensome, indicating that producing such reports might create a needless administrative cost.<sup>169</sup>

## 2. Statutory Mandate to Consider Costs and Benefits

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its action before promulgating a regulation.<sup>170</sup> In particular, costs and benefits must be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Accordingly, the Commission

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<sup>166</sup> FHLB letter at 6, MetLife letter at 2, EEI letter at 3.

<sup>167</sup> SIFMA/ISDA letter at 4, ISDA letter at 4, AMG letter at 7.

<sup>168</sup> Federated letter at 7, 11.

<sup>169</sup> Working Group letter at 6.

<sup>170</sup> 7 U.S.C. 19(a).

considers the costs and benefits resulting from its own discretionary determinations with respect to the section 15(a) factors.

In issuing these final rules, the Commission has considered the costs and benefits of each aspect of the rules, as well as alternatives to them. In addition, the Commission has evaluated comments received regarding costs and benefits in response to its proposal. Where quantification has not been reasonably estimable due to lack of necessary underlying information, the Commission has considered the costs and benefits of the final rules in qualitative terms.

### 3. Benefits and Costs of the Final Rule

A discussion of the costs and benefits of this rule and the relevant comments is set out immediately below and continues in the discussion of the section 15(a) factors. The discussion of costs and benefits here should be read in conjunction with the discussion of rule provisions and comments in the remainder of the preamble, which was also taken into account in the Commission's overall consideration of costs and benefits as part of its decision to promulgate the rule.

The major provisions of this final rule reflect specific requirements compelled by the CEA, as amended by the Dodd-Frank Act. This discussion of costs and benefits focuses on the areas in which the Commission used its discretion to introduce standards or requirements beyond those which were required by statute.

#### a. Benefits

The final rule, in regulation 23.701(e), requires notification of the right to segregation once per each year that a new swap is entered into rather than, e.g., at the beginning of a swap transaction or notification only when a counterparty first does

business with the SD or MSP. Annual notification offers the benefit of ensuring that the right to segregation is called to the attention of counterparties reasonably close in time to the point at which decisions are made with respect to the handling of collateral for particular swaps transactions without requiring excessive or repetitive notification in cases where a counterparty engages in multiple swaps with a particular SD or MSP over the course of a year. Annual notification also reduces the likelihood that required information regarding custodians and pricing will become obsolete, which would be a significant possibility if notification were given only at the beginning of a multi-year business relationship between a counterparty and the SD or MSP.

The final rule, in regulation 23.701(a)(2), requires the SD or MSP to identify, in the notification, at least one creditworthy non-affiliate acceptable to the SD or MSP as a custodian. As discussed above, there are benefits to requiring that the counterparty have the option of using a non-affiliate custodian for collateral because of the likely higher correlation of default risk between an affiliate custodian and the SD or MSP. There are also benefits to requiring the identity of such a custodian acceptable to the SD or MSP to be specifically disclosed because the identity of the custodian is a material aspect of any segregation package.

The final rule also requires, in regulation 23.701(a)(3), the SD or MSP to provide the counterparty with the price of segregation to the extent that the SD or MSP has such information (e.g., where the custodian is an affiliate of, or a regular custodian for, the SD or MSP). Requiring the SD or MSP to disclose price information that it has available is beneficial because knowledge of the price of segregation is essential in order for the counterparty to determine the net value of choosing segregation. In transactions in which

the parties have agreed that a withdrawal of segregated margin may be made without the written consent of both the counterparty and the SD or MSP, the final rule, in regulation 23.702(c)(2), includes a perjury standard for a party unilaterally representing to the custodian that it is entitled to segregated initial margin. The benefit of a perjury standard for unilateral requests for collateral is that it provides a disincentive to parties who might otherwise be inclined to fraudulently request collateral, particularly in circumstances where financial distress may create incentives to cut corners.

The final rule requires, in regulation 23.703(a), that any investments of segregated initial margin given to an SD or MSP conform to regulation 1.25. While not required by statute, this aspect of the final rule is beneficial because it will serve to safeguard segregated initial margin in the same way that regulation 1.25 safeguards futures and cleared swaps customer collateral. Without this requirement, there exists a possible moral hazard concern that an SD or MSP may engage in excessive risk taking with the funds of a counterparty. This moral hazard arises out of either (i) lack of customer awareness, (ii) agency costs facing the customer that make it difficult to contract around issues of collateral use (e.g., monitoring costs of the SD's or MSP's activities by the customer), or (iii) existence of a potential government backstop, which lessens the incentive of either SDs or MSPs or their customers to impose restrictions on collateral investment.

The final rule, in regulation 23.704(a), also makes the Chief Compliance Officer of the SD or MSP required by section 4s(k) of the CEA responsible for the report to each counterparty that elects not to require segregation whether or not the back office procedures relating to margin and collateral requirements of the SD or MSP were out of

compliance with the agreement between the SD or MSP and the counterparty, consistent with the Chief Compliance Officer's section 4s(k)(2)(D) of the CEA duties. This provision should enhance compliance by SDs and MSPs with these aspects of their agreements with their counterparties by highlighting breaches and by incentivizing SDs and MSPs to avoid breaches that would have to be reported. Compliance by SDs and MSPs with provisions concerning margin and collateral requirements should lead to better protection of counterparties in the event of the insolvency of the SD or MSP.

b. Costs

As noted previously, the final rule, in regulation 23.701(e), requires yearly notification of the right to segregation. This is less costly than a requirement that such notification be given with each swap transaction, which would result from a more literal reading of the statute.<sup>171</sup>

An estimate of the cost of the required yearly notification is given in the Paperwork Reduction Act section of this preamble, above. The Commission believes that the cost of requiring SDs and MSPs to deliver one notification per year to each counterparty is not overly burdensome, particularly when one considers the importance of the counterparty's decision to require segregation and the large dollar volume of business that is typically done by SDs and MSPs.<sup>172</sup> The increased cost associated with an annual notification requirement, as compared to a requirement that notification only be required at the beginning of a swap relationship between the parties as was urged by some

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<sup>171</sup> See CEA section 4s(l)(1)(A) (A swap dealer or major swap participant shall be required to notify the counterparty of the swap dealer or major swap participant at the beginning of a swap transaction that the counterparty has the right to require segregation.).

<sup>172</sup> See generally Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 FR 30596 (May 23, 2012).

commenters, is the difference in the administrative costs of sending each additional yearly notification as opposed to just one initial notification. Commenters who favored less-than-annual notification did not provide specific estimates of this cost difference. Based on its assessment of the cost of annual notification, the Commission does not believe that this cost difference would impose an unreasonable burden.<sup>173</sup>

The requirement that SDs or MSPs reveal to counterparties the identity of one or more potential custodians (one of which must be unaffiliated), and their respective prices of segregation, should impose minimal costs. It is likely that both the identities of custodians and related pricing information would, in the ordinary course, be included in any negotiation between an SD or MSP and a counterparty. In any event, the SD's or MSP's own custodial and pricing decisions are known (or certainly readily knowable) by the SD or MSP, and thus requiring them to be disclosed should introduce minimal cost upon the SD or MSP. There may be an administrative cost to the SD or MSP in initially selecting an unaffiliated custodian, if the SD or MSP did not previously have a relationship with such an entity. This administrative expense need only be a one-time cost and should not be overly burdensome.

The perjury standard introduces a heightened punishment for the inappropriate seizure of customer collateral based on false representations. The primary cost of such a standard is the exercise of excessive caution by SDs or MSPs in asserting their right to this collateral, even in instances where that right is warranted.

The requirement that investments of segregated margin given to an SD or MSP adhere to regulation 1.25 may impose costs. The primary cost would be a loss of

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<sup>173</sup> For the Commission's analysis and estimate of the costs of annual notification, please see the discussion in the Paperwork Reduction Act section of this preamble, above.

investment returns to SDs and MSPs under the rule as opposed to investment returns that would have been permitted without the regulation's restriction. Regulation 1.25 requires that investments of customer collateral by an SD or MSP adhere to a list of enumerated investments, concentration limits and other restrictions because certain investments may not adequately meet the statute's paramount goal of protecting customer funds.<sup>174</sup> Nonetheless, the Commission recognizes that restricting the type and form of permitted investments could result in certain SDs and MSPs earning less income from their investments of customer funds. The Commission has (conservatively) estimated the excess return (or spread) of investing without restrictions, as compared to investing according to regulation 1.25 guidelines, to be between 0% and 4%.<sup>175</sup> The associated cost of imposing regulation 1.25, which needs to also consider the (risk-based) preferences of counterparties over the set of foregone investment opportunities, exists somewhere within this range. Secondly, there may be administrative costs to SDs and MSPs in ensuring compliance with regulation 1.25 limitations. However, the Commission notes that parties are free to negotiate arrangements outside of the final rule.

An estimate of the cost of the quarterly reporting required pursuant to regulation 23.704 is given in the Paperwork Reduction Act section of this preamble, above. As noted above, the Chief Compliance Officer and junior compliance officers' time may result in an added cost to the implementation of regulation 23.704. The Chief Compliance Officer's involvement with design and implementation of these procedures, however, is commensurate with its section 4s(k)(2)(D) CEA responsibilities for

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<sup>174</sup> See generally 7 U.S.C. 6d.

<sup>175</sup> This range is based on an average yield on 10-year T-bonds between 4% and 6% and a long-run annualized return on equities between 6% and 8%.

“administrating each policy and procedure that is required to be established pursuant to [section 4s].” In addition, this cost is outweighed by the relative benefit of the design and implementation of effective recordkeeping procedures for the large number of counterparties served by each SD or MSP.

### c. Consideration of Alternatives

In arriving at the final rules, in areas in which the Commission exercised its discretion, the Commission has considered a number of alternatives suggested by commenters.

The Commission asked in the NPRM whether the SD or MSP should be required to disclose the price of segregation, the fees to be paid to the custodian (if the SD or MSP was aware of such costs) or differences in the terms of the swap that the SD or MSP is willing to offer to the counterparty if the counterparty elects or renounces the right to segregation. SIFMA/ISDA wrote that mandating disclosure is not necessary or desirable because “a counterparty can always, in accordance with current market practice, request disclosures it considers necessary from its SD/MSP ... [and] mandatory disclosure by the SD/MSP is impractical because much of the material costs are within the control of a third party: the custodian.”<sup>176</sup> ICI sought to distinguish between fees charged by the custodian – which ICI does not believe need to be disclosed by the SD or MSP – and fees embedded in the SD’s or MSP’s pricing.<sup>177</sup> State Street suggested that “the Commission should ... provide that, although the pricing of the same transaction with and without a segregated account may differ, the pricing difference should be reflective of actual out-of-pocket costs expected to be incurred by the [SD or MSP] as a result of use of the

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<sup>176</sup> SIFMA/ISDA letter at 3 and ISDA letter at 3-4.

<sup>177</sup> ICI letter at 3.

segregated account, and that the nature and amounts of those costs should be fully disclosed.”<sup>178</sup>

The Commission could have chosen to take the path requested by SIFMA/ISDA, in which no disclosures are mandated by the regulation, or the path requested by ICI, in which only fees embedded in the SD’s or MSP’s pricing for segregated margin are disclosed. However, as discussed by several commenters, what is relevant to the counterparty in determining whether to segregate (and with which custodian) is the sum of all associated costs;<sup>179</sup> both those directly associated with the custodian, and any additional charges imposed by the SD or MSP.

The SD or MSP will typically be in a better position to know the fees charged by the custodian than the counterparty. In such instances, the alternatives suggested by SIFMA/ISDA and ICI could result in a lack of pricing information for the counterparty, or at best, a more difficult path for a counterparty to obtain such information. The SD or MSP is responsible for segregation and for using an independent third-party custodian, and providing price information about the total cost of segregation to the counterparty is a key component of evaluating a custodian’s service.

The Commission notes State Street’s argument, but believes that mandating that the difference in prices charged by the SD or MSP should only reflect the SD’s or MSP’s out-of-pocket costs would be excessively proscriptive. To the extent that this rule promotes price transparency, it will foster more competitive pricing.

In addition, several commenters requested the Commission eliminate the once-per-year notification in the Commission’s proposed rule. SIFMA/ISDA and AMG each

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<sup>178</sup> State Street letter at 3.

<sup>179</sup> See generally MFA Letter at 4 and State Street letter at 3.

wrote that an initial notification is all that should be required. The Commission considered requiring only an initial notification, however it opted for a yearly notification. Yearly notification serves as an appropriate means for calling attention to the importance of the right to segregate collateral, and offers a number of benefits, relative to one-time-only disclosure, as has been discussed above. Similarly, the Commission has concluded that any difference in administrative costs should not be excessively burdensome.

The alternative to a perjury standard for unilateral requests to withdraw collateral from segregation is not to have one. However, it is the Commission's view that heightening the penalty for fraudulently requesting funds to which one is not entitled reduces the incidence of such claims, and may serve the general intent of section 4s(1) to increase the safety and financial integrity of the uncleared swap market and to safeguard the initial margin of parties to uncleared swaps, once segregated, while still providing the benefits of a unilateral ability to withdraw collateral to parties who agree to such an approach.<sup>180</sup>

The alternatives to subjecting the investment of segregated initial margin to regulation 1.25 are to subject it to no restrictions at all or to subject it to some other collateral investment regime. The Commission notes that none of the commenters proposed an alternative investment framework or detailed set of restrictions.<sup>181</sup> It is the Commission's view that the purpose of section 4s(1) is to increase the safety of the

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<sup>180</sup> As discussed below, the perjury rule may in certain instances lead to excess caution by SDs and MSPs in cases where they do have a right to the collateral. In such instances, the perjury rule could adversely affect sound risk management.

<sup>181</sup> While Federated provided some general suggestions, such as setting concentration limits on investments with a particular fund or family of funds, it argued that there "should be no limits on investment of collateral for uncleared or cleared swaps." See Federated letter at 10-11.

uncleared swaps market and to protect initial margin, once segregated. Regulation 1.25 is used by the Commission for both futures and cleared swaps as a means by which to protect segregated customer funds against risky investment. Having created a legal standard for this purpose, it makes sense to apply it to uncleared swaps transactions in which counterparties choose to have their collateral segregated within a regulatory framework established by the Commission under the authority of section 4s(1).

Alternatives to reporting requirements to non-segregated collateral would be to require reports less frequently than quarterly and to not place responsibility for such reports on the chief compliance officer. The Commission notes that while quarterly reporting may impose certain administrative burdens on SDs and MSPs, such quarterly reporting, as contemplated by regulation 23.704, is expressly required by the statute.<sup>182</sup> In addition, under section 4s(k)(2)(D) of the CEA, the chief compliance officer is “responsible for administering each policy and procedure that is required to be established pursuant to [section 4s].” Thus, responsibility for compliance with the quarterly reporting requirement, a procedure required by section 4s(1)(4) of the CEA, properly rests with the chief compliance officer.

#### 4. Section 15(a) Factors

As noted above, in this final rule, the Commission considers the costs and benefits that result from the regulations issued herein according to the requirements of section 15(a) of the CEA. Previous sections identify four main issues for cost-benefit

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<sup>182</sup> The reporting requirement found in section 4s(1)(4) of the CEA states that if the counterparty does not choose to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty, the swap dealer or major swap participant shall report to the counterparty of the swap dealer or major swap participant on a quarterly basis that the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements are in compliance with the agreement of the counterparties.

considerations: (1) notification of the right to segregate, (2) requirements to reveal the price of segregation, (3) statements affirming the right to seize collateral, and (4) adherence to regulation 1.25 in the investment of segregated collateral. This section discusses those considerations in light of the section 15(a) criteria described above.

a. Annual Notification of the Right to Segregate

This requirement ensures that the right to segregation is called to the attention of counterparties reasonably close in time to the point at which they make decisions regarding the handling of collateral for particular swaps transactions and therefore increases the likelihood that counterparties will make informed decisions on whether to elect segregation. It thereby furthers the protection of market participants and the public and promotes sound risk management practices.

b. Revealing the Price of Segregation and Identifying a Custodian

The statute requires the SD or MSP to notify the counterparty of its right to segregation. The final regulation goes beyond the statutory requirement by also requiring that the SD or MSP provide an unaffiliated custodian that it would be willing to use as well as the price associated with segregation. The Commission has determined that the benefits for this requirements are compelling and do not entail any significant costs.

The requirement also promotes the protection of market participants and the public and promotes sound risk management practices. The ability of a counterparty to know the custodian and the price associated with segregation is important because it facilitates the counterparty's decisions regarding whether to segregate initial margin and with whom it wishes to transact swaps. In addition to benefitting counterparties facilitating decisions regarding protection of collateral in uncleared swaps transactions

benefits the public. Notwithstanding the movement towards clearing, a large number of swaps will remain bilateral contracts. Congress has determined that systemic risk will be reduced by offering counterparties the right to segregate collateral to avoid losses brought about by default of an SD or MSP and providing information on custodians and pricing promotes the exercise of this right.

This requirement also promotes market efficiency, competitiveness and financial integrity by facilitating counterparty comparison of custodians, which may influence its choice of the SD or MSP with which it wishes to transact swaps. To the extent that such price transparency promotes competition among custodians, one can expect reductions in the cost of segregation, which, in turn, may lead to increased use of the segregation option, with the resultant positive implications for sound risk management practices. Second, requiring that pricing information be obtained by the party best positioned to know such information eliminates a circumstance where a party at a comparative disadvantage for obtaining such information has to do so.

c. Perjury Standard for Statements Affirming the Right to Unilaterally Withdraw Collateral from a Custodian

The baseline for comparison of this requirement is typical market practice, which may include civil and criminal actions against a party falsely claiming that it is entitled to funds to which it, in fact, is not.

Introducing a perjury standard for unilateral requests for collateral will serve as an additional disincentive for parties who might otherwise be inclined to fraudulently request collateral. To the extent this standard reduces the incidence of such false claims, the rule acts to promote the protection of market participants and the public. In addition,

fraudulent requests for collateral, if honored, can shake victimized parties' confidence in the uncleared segregation regime and damage public confidence in the safety of the uncleared swap market. Heightening disincentives for fraudulent conduct will therefore help to safeguard the financial integrity of the uncleared swap market place. As previously mentioned, a primary cost of this standard is the exercise of excessive caution by SDs or MSPs in asserting their right to this collateral, even in instances where the SD or MSP believes that the unilateral withdrawal of such collateral is authorized, because of the costs and risks of exposure to a potential criminal action. To the extent that this potential cost arises, therefore, the requirement can negatively impact the practice of sound risk management.

d. Adherence to Regulation 1.25

Absent this requirement, an SD or MSP's investment options for collateral would be left up to the negotiation of the counterparties.

As discussed above, without this requirement, there exists a possible moral hazard concern that an SD or MSP may engage in excessive risk taking with the funds of a counterparty. The Commission agrees with commenters who claim that this requirement may constrain the investment returns of SDs and MSPs relative to those returns achievable absent the enhanced safety criteria. Recognizing that there may be some reduction in returns, applying regulation 1.25 standards to segregated initial margin of uncleared swaps will benefit market participants and the public by safeguarding such segregated funds.

This regulation also benefits the financial integrity of the market place. A party who invests its customer's segregated funds is required to replenish any losses in the

customer account with its own funds. During a period of market stress, such a party might be experiencing losses in other areas, which may increase the difficulty of making the customer whole. In that regard, even if there are not losses in the customer account, strains on the SD's or MSP's sources of funds may cause delays in a counterparty receiving funds to which it is entitled. Regulation 1.25 requires that customer fund investments be made in an enumerated list of instruments which preserve principal and maintain liquidity.

Finally, requiring that investments of segregated initial margin adhere to regulation 1.25 benefits sound risk management practices by ensuring that segregated funds are invested in a safe manner. This benefits the counterparty, whose initial margin is safeguarded, and the market as a whole, because of the decreased likelihood of a market shock causing a chain reaction which results in the loss of segregated funds. While the Commission realizes that there may be administrative costs in ensuring that regulation 1.25 requirements are followed, the Commission expects that SDs and MSPs are sophisticated firms that should be able to make the necessary adjustments without much delay or expense. The overall benefits of safeguarding segregated funds and the resultant reductions in risk to portfolios, as compared to those based on a regulatory framework without such limitations, exceed those costs.<sup>183</sup>

## **List of Subjects**

### 17 CFR Part 23

Consumer protection, Reporting and recordkeeping requirements, Swaps.

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<sup>183</sup> Based on the subject matter of the rule and comments received, the Commission does not expect the rule to have a significant effect on price discovery or on other public interest considerations not already discussed.

17 CFR Part 190

Bankruptcy, Brokers, Commodity futures, Reporting and recordkeeping requirements, Swaps.

For the reasons stated in the preamble, the Commodity Futures Trading Commission amends 17 CFR parts 23 and 190 as follows:

**PART 23 – SWAP DEALERS AND MAJOR SWAP PARTICIPANTS**

1. The authority citation for part 23 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 6, 6a, 6b, 6b-1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21.

2. Add and reserve subpart K.
3. Add subpart L to read as follows:

**Subpart L – Segregation of Assets Held as Collateral in Uncleared Swap Transactions**

Sec.

23.700 Definitions.

23.701 Notification of right to segregation.

23.702 Requirements for segregated margin.

23.703 Investment of segregated margin.

23.704 Requirements for non-segregated margin.

**Subpart L – Segregation of Assets Held as Collateral in Uncleared Swap Transactions**

§23.700 Definitions.

As used in this subpart:

Initial Margin means money, securities, or property posted by a party to a swap as performance bond to cover potential future exposures arising from changes in the market value of the position.

Margin means both Initial Margin and Variation Margin.

Segregate. To segregate two or more items is to keep them in separate accounts, and to avoid combining them in the same transfer between two accounts.

Variation Margin means a payment made by or collateral posted by a party to a swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market.

§23.701 Notification of right to segregation.

(a) Prior to the execution of each swap transaction that is not submitted for clearing, a swap dealer or major swap participant shall:

(1) Notify each counterparty to such transaction that the counterparty has the right to require that any Initial Margin the counterparty provides in connection with such transaction be segregated in accordance with §23.702 and §23.703;

(2) Identify one or more custodians, one of which must be a creditworthy non-affiliate and each of which must be a legal entity independent of both the swap dealer or major swap participant and the counterparty, as an acceptable depository for segregated Initial Margin; and

(3) Provide information regarding the price of segregation for each custodian identified in paragraph (a)(2) of this section, to the extent that the swap dealer or major swap participant has such information.

(b) The right referred to in paragraph (a) of this section does not extend to Variation Margin.

(c) The notification referred to in paragraph (a) of this section shall be made to an officer of the counterparty responsible for the management of collateral. If no such party

is identified by the counterparty to the swap dealer or major swap participant, then the notification shall be made to the Chief Risk Officer of the counterparty, or, if there is no such Officer, the Chief Executive Officer, or if none, the highest-level decision-maker for the counterparty.

(d) Prior to confirming the terms of any such swap, the swap dealer or major swap participant shall obtain from the counterparty confirmation of receipt by the person specified in paragraph (c) of this section of the notification specified in paragraph (a) of this section, and an election to require such segregation or not. The swap dealer or major swap participant shall maintain such confirmation and such election as business records pursuant to §1.31 of this chapter.

(e) Notification pursuant to paragraph (a) of this section to a particular counterparty by a particular swap dealer or major swap participant need only be made once in any calendar year.

(f) A counterparty's election to require segregation of Initial Margin, or not to require such segregation, may be changed at the discretion of the counterparty upon written notice delivered to the swap dealer or major swap participant, which changed election shall be applicable to all swaps entered into between the parties after such delivery.

§23.702 Requirements for segregated margin.

(a) The custodian of Margin, segregated pursuant to an election under §23.701, must be a legal entity independent of both the swap dealer or major swap participant and the counterparty.

(b) Initial Margin that is segregated pursuant to an election under §23.701 must be held in an account segregated for and on behalf of the counterparty, and designated as such. Such an account may, if the swap dealer or major swap participant and the counterparty agree, also hold Variation Margin.

(c) Any agreement for the segregation of Margin pursuant to this section shall be in writing, shall include the custodian as a party, and shall provide that:

(1) Any withdrawal of such Margin, other than pursuant to paragraph (c)(2) of this section, shall only be made pursuant to the agreement of both the counterparty and the swap dealer or major swap participant, and notification of such withdrawal shall be given immediately to the non-withdrawing party;

(2) Turnover of control of such Margin shall be made without the written consent of both parties, as appropriate, to the counterparty or to the swap dealer or major swap participant, promptly upon presentation to the custodian of a statement in writing, made under oath or under penalty of perjury as specified in 28 U.S.C. 1746, by an authorized representative of either such party, stating that such party is entitled to such control pursuant to an agreement between the parties. The other party shall be immediately notified of such turnover.

§23.703 Investment of segregated margin.

(a) Margin that is segregated pursuant to an election under §23.701 may only be invested consistent with §1.25 of this chapter.

(b) Subject to paragraph (a) of this section, the swap dealer or major swap participant and the counterparty may enter into any commercial arrangement, in writing,

regarding the investment of such Margin, and the related allocation of gains and losses resulting from such investment.

§23.704 Requirements for non-segregated margin.

(a) The chief compliance officer of each swap dealer or major swap participant shall report to each counterparty that does not choose to require segregation of Initial Margin pursuant to §23.701(a), no later than the fifteenth business day of each calendar quarter, on whether or not the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements were, at any point during the previous calendar quarter, not in compliance with the agreement of the counterparties.

(b) The obligation specified in paragraph (a) of this section shall apply with respect to each counterparty no earlier than the 90<sup>th</sup> calendar day after the date on which the first swap is transacted between the counterparty and the swap dealer or major swap participant.

PART 190 – BANKRUPTCY

3. The authority citation for part 190 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 4a, 6c, 6d, 6g, 7a, 12, 19, and 24, and 11 U.S.C. 362, 546, 548, 556, and 761-766, unless otherwise noted.

4. In §190.01, revise paragraph (l) to read as follows:

§190.01 Definitions.

\* \* \* \* \*

(l) Customer shall have the same meaning as that set forth in section 761(9) of the Bankruptcy Code. To the extent not otherwise included, customer shall include the

owner of a portfolio margining account carried as a futures account or cleared swaps customer account.

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5. In §190.08, redesignate paragraph (a)(1)(i)(F) as paragraph (a)(1)(i)(G) and add new paragraph (a)(1)(i)(F) to read as follows:

§190.08 Allocation of property and allowance of claims.

\* \* \* \* \*

(a) \* \* \*

(1) \* \* \*

(i) \* \* \*

(F) To the extent not otherwise included, securities held in a portfolio margining account carried as a futures account or a cleared swaps customer account;

\* \* \* \* \*

Issued in Washington, DC, on October 31, 2013, by the Commission.

Melissa D. Jurgens,

Secretary of the Commission.

**Appendices to Protection of Collateral of Counterparties to Uncleared Swaps;  
Treatment of Securities in a Portfolio Margining Account in a Commodity Broker  
Bankruptcy – Commission Voting Summary and Statement of Chairman**

NOTE: The following appendices will not appear in the Code of Federal Regulations.

## **Appendix 1 – Commission Voting Summary**

On this matter, Chairman Gensler and Commissioners Chilton, O’Malia, and Wetjen voted in the affirmative; no Commissioner voted in the negative.

## **Appendix 2 – Statement of Chairman Gary Gensler**

I support the final rule enhancing the protection of customer funds when entering into uncleared swap transactions. Today’s final rule fulfills Congress’ mandate that counterparties of swap dealers be given a choice regarding whether or not they get the protections that come from segregation of monies and collateral they post as initial margin. These are important customer protections for counterparties as they enter into customized swaps with swap dealers.

Swap dealers will be required to give each of their counterparties the choice with regard to segregation. The dealers also will have to provide the prices for the various segregation choices. Further, the dealers must give the customers at least one custodial arrangement choice not affiliated with the swap dealer’s bank.

In addition, this rule provides clarifying changes to ensure that if a counterparty chooses segregation for its funds, those funds will not be tied up in the bankruptcy of its swap dealer.

These rules are critical to protecting insurance companies, pension funds, community banks and municipal governments wishing to hedge a risk in using the customized swaps market.

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